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Japan: Financial System Stability Assessment and Supplementary Information

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JAPAN

Financial System Stability Assessment

Prepared by the Monetary and Financial Systems and Asia and Pacific Departments

Approved by Stefan Ingves and David Burton

August 5, 2003

- This Financial System Stability Assessment is based on the work of three FSAP missions that visited Japan in June 2002, October 2002, and March 2003. Follow-up discussions on the FSAP in the context of the 2003 Article IV consultations took place during May 22–June 4, 2003.

- The FSAP team over the three missions was led by Stefan Ingves and included Paul Hilbers, Peter Hayward, Paul Kupiec, Mark Stone, Mats Filipsson, Jingqing Chai, Yuri Kawakami (all MFD), Kenneth Kang (APD), Nadim Kyriakos-Saad and Thomas Laryea (both LEG), Christopher Morris (ICM), Romuald Semblat (OAP), Donald McIsaac (World Bank), Alan Cameron (formerly Australian Securities and Investment Commission), Helmut Müller (formerly German Insurance Supervisory Agency), Sean O'Connor (Bank of Canada), Daniela Russo (European Central Bank), William Ryback (Federal Reserve Board), Charles Siegman (formerly Federal Reserve Board), Stefan Spamer (Bundesbank), and Tarisa Watanagase (Bank of Thailand). Silvia Ramirez and Megan Thomas (both MFD) provided research and administrative assistance respectively. Haruyuki Toyama (former Alternate Executive Director for Japan) joined a number of the mission meetings.

- The Japanese financial sector remains weak notwithstanding a series of policy measures. Financial sector vulnerabilities are rooted in the absence of a sustained economic recovery and high corporate sector leverage. The capital position and profitability of banks and life insurers are weak, and nonperforming loans, although declining, remain high. As a result, financial sector weakness has held back prospects for a sustained recovery. Systemic vulnerability has been limited by the well-developed safety net, the low level of nominal interest rates, and the strong external position. Recent government initiatives are important steps in the right direction, but confidence in the system is still reliant on the safety net. The staff's view is that the financial system remains fragile, and that a more comprehensive and accelerated approach is required to restore the health of the financial system.

- To this effect, staff emphasizes the need for effective government intervention to address both the "stock" problem related to the weak capital base and poor asset quality, and the "flow" problem arising from the low profitability of the sector. The staff recommends tackling the stock problem through steps to recapitalize the banks, restructure bad loans, and tighten supervision, while addressing the flow problem by reducing the government's role in financial intermediation, strengthening corporate governance, and promoting further consolidation. In assessing compliance with key financial sector standards and codes, the staff believes that additional resources and enhanced autonomy would help the Financial Services Agency to carry out more effectively its supervisory responsibilities; other key aspects of the financial framework, including the payment and settlement systems and the level of transparency, appeared sound.

- The main authors of this report are Paul Hilbers, Peter Hayward, Mark Stone, Kenneth Kang, and Jingqing Chai.

FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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Main Websites of the Japanese Financial System Authorities

Bank of Japan..http://www.boj.or.jp/en/index.htm
Financial Services Agency..http://www.fsa.go.jp/indexe.html
Ministry of Finance..http://www.mof.go.jp/english/index.htm

ACRONYMS

AML/CFT	Anti-money laundering and combating the financing of terrorism
BoJ	Bank of Japan
BoJ-NET FTS	BoJ-NET Funds Transfer System
CPSIPS	CPSS Core Principles for Systemically Important Payment Systems
CPSS	Committee on Payment and Settlement Systems
CSDs	Central securities depositories
DIC	Deposit Insurance Corporation
DIL	Deposit Insurance Law
DTAs	Deferred tax assets
DVP	Delivery-versus-payment
FILP	Fiscal Investment and Loan Program
FRC	Financial Reconstruction Commission
FSA	Financial Services Agency
FSAL	FSA Law
FSAP	Financial Sector Assessment Program
FXYCS	Foreign Exchange Yen Clearing System
FY	Financial year (ends on March 31 of the next calendar year)
GFI	Government financial institution
GHLC	Government Housing Loan Corporation
GPIF	Government Pensions Investment Fund
IAIS	International Association of Insurance Supervisors
IOSCO	International Organization of Securities Commissions
IRCJ	Industrial Revitalization Corporation of Japan
JAFIO	Japan Financial Intelligence Office
JASDEC	Japan Securities Depository Center
JBIC	Japan Bank for International Corporation
JGBs	Japanese government bonds
JICPA	Japanese Institute of Certified Public Accountants
JSDA	Japan Securities Dealers Association
LFBs	Local finance bureaus
LOLR	Lender of last resort
MFPTC	Code of Good Practices on Transparency in Monetary and Financial Policies
MoF	Ministry of Finance
NPLs	Nonperforming loans
OTC	Over-the-counter
PCA	Prompt corrective action
PFR	Program for Financial Revival
PSA	Postal Services Agency
RCC	Resolution and Collection Corporation
RTGS	Real-time gross settlement system
SDDS	Special Data Dissemination Standard
SEL	Securities and Exchange Law
SESC	Securities and Exchange Surveillance Commission
SMEs	Small-and-medium-sized enterprises
TBA	Tokyo Bankers Association
TCH-BCCS	Tokyo Clearing House Bill and Check Clearing System
TSE	Tokyo Stock Exchange

I. OVERALL STABILITY ASSESSMENT

A. Financial Stability and Structural Change in a Deflationary Environment

1. **More than a decade has passed since the bursting of the asset price bubble in Japan, yet major financial sector weaknesses remain.** Financial sector vulnerabilities are rooted in the absence of a sustained economic recovery and high corporate sector leverage. The capital position and profitability of banks and life insurers are weak, and nonperforming loans, although declining, remain high. In addition, financial institutions are exposed to significant market and credit risks. As a result, financial sector weakness has held back prospects for a sustained recovery.

2. **Low growth has prolonged and intensified financial weakness and vulnerability.** The prolonged economic slowdown has constrained bank profitability and exacerbated the bad loan problem, while continued deflation has added to real debt burdens, raised corporate bankruptcies, and eroded collateral values. Ample liquidity and low interest rates have made it easier for banks to delay recognizing problem loans, and despite the exit of a significant number of institutions over the past few years, many weak institutions continue to operate, holding back the profitability and consolidation of the sector.

3. **The authorities have taken important regulatory and legal steps to address financial sector problems in recent years.** These include the establishment of the Financial Services Agency (FSA), government recapitalization of major banks in 1998/99, and enhancement of the safety net (Box 1). The recent adoption of a Program for Financial Revival (PFR) marks a positive step in reforms aimed at strengthening the financial sector. In response to the stricter regulatory environment, banks have attempted to improve their capital adequacy, raise provisioning, and accelerate NPL disposal.

4. **Nevertheless, the financial system remains fragile, and although in the short run a systemic crisis seems unlikely, expeditious and forceful action is required to avoid further deterioration.** The strong external position means Japan is not vulnerable to the balance of payments shocks that have triggered crises in other countries with vulnerable financial systems. Further, systemic risk is mitigated by effective government safety nets. However, if the credibility of government support for the financial system were to come into question, the system could come under pressure and liquidity problems might emerge, given the reliance on sizeable short-term domestic funding at very low costs. The various linkages between financial institutions with each other and the rest of the economy mean that the consequences of such pressures on the system are highly uncertain and potentially risky.

5. **Government intervention will be required to reduce the risks.** Over the past decade, it has become clear that financial institutions have not been able to solve the problems on their own. Effective government intervention is thus needed to address the causes and not the symptoms of the problems, with the key aim of restoring the health and profitability of the financial sector. Staff’s key recommendations are summarized in Box 2.

Box 1. Japan: Key Financial System Reforms, 1996–2003

1996: The "Big Bang." Removal of the remaining legal barriers separating ownership of banks, trust banks, securities firms, and insurance companies; removal of the long-standing ban on holding companies, also allowing the creation of financial groups (although no direct bancassurance groups have emerged yet). **Safety net** enhanced including temporary comprehensive deposit insurance.

1997/98: Crisis resolution measures. Three large weak banks successfully resolved: one by acquisition of viable assets and liabilities by existing institutions, and two taken over by the government and resold to new investors. One large securities company wound up. A number of smaller institutions also successfully resolved. Resolution and Collection Bank (RCB) functions as an asset management and realization company.

1998: Banking law reform. Prompt corrective action (PCA) procedures established. Financial Supervisory Agency established under Financial Reconstruction Commission (FRC) to oversee rehabilitation of the financial sector and improve supervision. Inspection manual prepared and published, designed to promote more effective loan valuation and provisioning practices (introducing so-called self-assessment process). Securities and Exchange Surveillance Commission (SESC) moved from the Ministry of Finance (MoF) to the Financial Supervisory Agency.

Bank of Japan (BoJ) law passed, establishing an independent central bank. BoJ's right to examine counterparty financial institutions explicitly confirmed.

1998–99: Bank recapitalization: Additional large banks recapitalized by the government and subjected to performance conditions.

1999: Insolvency law reformed under Civil Rehabilitation Law. Disclosure regime enhanced. Banks required to disclose more information on asset quality and unrealized gains/losses on securities' holdings. The Resolution and Collection Corporation (RCC) created to collect bad loans from failed housing loan companies, banks, and credit cooperatives.

2000: Safety net enhanced. New deposit insurance law codifying the safety net including a crisis management framework. PCA procedures strengthened. Accounting reforms introduced, including consolidated accounting and mandatory use of market values for securities. Financial Supervisory Agency renamed Financial Services Agency (FSA).

2001: FSA takes over functions of the FRC. Position of Minister for Financial Services within the Cabinet set up. **Accounting Standards Board of Japan** established to complete task of bringing accounting standards into line with international best practice. **Fiscal Investment and Loan Program (FILP) reforms** for financing of government-owned institutions enacted. **Special inspections** by the FSA leading to more realistic loan loss provisioning.

2002: Comprehensive deposit insurance withdrawn; large time deposits no longer insured. **Government and BoJ establish schemes for purchasing bank equity holdings. Program for Financial Revival published;** key elements include: (i) new inspection of major banks' loan classification and provisioning; (ii) introducing discounted cash flow (DCF) methodology for provisioning loans to large "special attention" borrowers; (iii) harmonizing loan classification for large borrowers across banks; (iv) disclosing the gap between major banks' self-assessment of problem loans and FSA assessment; and (v) external auditing of capital adequacy ratios, starting in FY2003.

2003: Industrial Revitalization Corporation of Japan (IRCJ) set up to promote more effective corporate restructuring. **Another round of special inspections** leading banks to raise external capital and set up asset resolution companies, often in conjunction with international investors. **Japan Post** incorporated. The Securities and Exchange Law and other related laws changed to introduce a **"fit and proper" test on principal shareholders** of securities companies, investment trust management companies, and discretionary investment advisors.

Box 2. Key Policy Recommendations

Asset quality and bank capital

Further strengthen banks' provisioning for NPLs, including by extending the use of forward-looking expected loss estimates.

Limit the use of deferred tax assets in calculating bank capital.

Bank recapitalization

Encourage banks to raise from the markets the additional capital needed to meet requirements due to the stricter treatment of deferred tax assets and provisioning.

Recapitalize those systemically important banks that are unable to raise sufficient capital in the market to at least 8 percent.

Require recapitalized banks to bring in new management.

Raise the minimum capital requirement for domestic banks to at least 8 percent.

Bank governance

Require banks to adopt corporate governance reforms consistent with the Basel Committee's guidelines, including outside directors and a board audit committee.

Corporate restructuring

Encourage banks to set up subsidiary "work-out" companies.

Develop further the market for distressed debt by having the Resolution and Collection Corporation (RCC) and the Industrial Revitalization Corporation of Japan (IRCJ) serve as a catalyst for transferring impaired assets from the banks to the private sector.

Supervision

Reform the governance of the supervisory process to give the FSA full operational autonomy and confine its responsibilities to supervision.

Provide additional resources to the FSA and continue to enhance its human capital.

Government involvement in the financial sector

Reduce government involvement in the financial sector by restricting the activities of the postal savings and insurance schemes and the government lending agencies.

Government intervention would need to decisively address both the "stock" problem related to the weak capital base and poor asset quality, and the "flow" problem arising from the low profitability of the sector. The staff recommends tackling the stock problem through steps to recapitalize the banks, restructure bad loans, and tighten supervision, while addressing the flow problem by reducing the government role in financial intermediation, strengthening corporate governance, and promoting further consolidation.

6. **Staff believes that the long-run benefits of reform exceed the short-run costs.** The costs include the possible short-run adverse impact on the economy and the use of public funds. The long-run benefits of reform arise from a strengthened financial system that can do without public assistance and contribute to a sustained economic recovery. Financial sector reforms and corporate restructuring combined with supportive macroeconomic policies would help strengthen the financial sector and provide the foundation for sustainable growth.[1]

B. Banking Sector

7. **Better treatment of impaired bank assets and stronger provisioning requirements would help clarify banks' capital positions and improve incentives.** Banks need to make more extensive use of forward-looking expected loss estimates, rather than rely on historical loss experience for provisioning. In particular, low nominal interest rates have eased the financing constraint on inherently unprofitable borrowers and made it more difficult to assess borrower viability. Underprovisioning has hampered the transfer of bad assets to the Resolution and Collection Corporation (RCC) and to the private sector. To facilitate provisioning, the tax authorities should allow provisions required by the supervisors to be recognized as a cost for tax purposes (the Tax Commission has recently proposed examining this issue further).

8. **The banking system's capital position is weak and requires expeditious strengthening.** The banking system's capital cushion has been run down to minimal levels. Most new capital raised by banks has been in the form of preferred securities and other forms of interest-bearing paper that are not the basis for stronger balance sheets. A recapitalization scheme will require preparation and cannot be implemented overnight, but not addressing capital adequacy issues will delay effective resolution of the key NPL problem and will constrain the supply of credit. Deferred tax assets now account for more than half of the Tier-1 capital in major banks but their value depends on the resumption of taxable profits. Since they are not generally available to meet losses, the FSA should limit the use of deferred tax assets as regulatory capital. After limiting deferred tax assets in bank capital and taking steps to strengthen provisioning requirements, any systemically important banks unable to raise additional private capital should be recapitalized with public funds to at least 8 percent. Non-viable banks should be wound down or merged to promote further consolidation in the banking sector. The minimum capital requirement for domestically-active banks should be progressively raised to 8 percent.

9. **Banks should adopt corporate governance reforms consistent with the Basel Committee's guidelines.** This would include new FSA regulations requiring the appointment of qualified outside directors and a board audit committee consisting of at least

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[1] The Staff Report for the 2003 Article IV Consultation for Japan discusses financial sector reforms in the context of an overall policy package.

a majority of outside directors. For banks that receive public funds, new leadership should be required and a public governance framework would need to be put in place to protect management from outside pressures and give them a clear mandate to restructure the banks' operations in preparation for reprivatization. Improvements in corporate governance would also have the important benefit of developing the market for contested takeovers and facilitating the consolidation of the banking system. The government's actions in the Resona case to adopt the new committee system are encouraging.

10. **The Japan Post—the largest deposit taker in the world—and the government financial institutions reduce the ability of private banks to compete.** These institutions benefit from subsidies and other advantages and are subject to limited prudential supervision. The government should gradually run down its involvement in financial intermediation, both as a deposit taker and as a lender, by restricting the activities of the postal savings and insurance schemes and of the government-owned lending and guarantee agencies.

11. **The implementation of the recommended financial reforms can be expected to accelerate the pace of consolidation and improve profitability of the banking system.** Despite the exit of a large number of banks, there remain more than 100 regional banks and a very large number of cooperative institutions. The pace of consolidation has been slow, reflecting adherence to existing business models, the relative financial weakness of even the stronger banks, the extent of cross-holdings among financial institutions and their customers, and the limited value of the deposit taking franchise in a zero interest rate environment. Comprehensive financial reforms would help promote the consolidation of the banking sector and raise profit margins.

C. Life Insurance

12. **Life insurance companies are under considerable stress as a result of the declines in investment income and stock prices, which have weakened their capital base.** The large decline in equity prices over the past few years has lowered the solvency margins for a number of life insurers, although all still remain above the regulatory minimum. The vulnerabilities of the Japanese insurance sector have potential systemic impact on the banking system through the linkages of cross-shareholding. With investment returns below the guaranteed yields to their policyholders (i.e., the "negative spread" problem), life insurers have experienced losses, which they have so far offset with expected gains from lower mortality and expenses. Life insurers and their actuaries should be required to revalue their policy liabilities to account for currently lower investment returns. Insurers should be required to set aside deficiency reserves against known losses on investment returns. At the same time, to provide a more accurate picture of their financial health, the FSA should strengthen the solvency margin calculations, taking into account the internal risk-based formulae used by life insurance companies.

D. Corporate Sector

13. **The financial structure of the corporate sector in Japan has potential systemic implications not present in other G-7 countries.** The corporate sector is highly leveraged,

and deflation has increased the real burden of debt. Moreover, the share of Japanese corporate financing provided by banks exceeds that of most G-7 countries. As a result, the financial sector is more directly exposed to weaknesses in the corporate sector.

14. **The corporate governance system in Japan is now undergoing important changes**. Recent improvements include raising Japanese standards for accounting to near international best practices, a strengthening of the accounting and auditing framework, and the revision to the Commercial Code in April 2003 giving corporations the option of a governance structure with a majority of outside directors. The changes should help improve the current governance system, which is still seen as marked by a low level of shareholder activism, few outside directors, and in need of greater transparency. In addition, the relatively small corporate bond market and still high degree of cross-shareholding also deter structural change. Further development of the capital markets would help to promote investor activism, and healthy banks would enhance discipline and strengthen the position of creditors in the corporate restructuring process.

E. Supervisory, Transparency, and Market Integrity Framework

15. **The establishment of the FSA in July 2000 was a key organizational step in strengthening and integrating financial sector supervision, although further improvements in a number of areas are still desirable.** The lack of a board creates scope for the FSA to be subject to political and industry pressures, and in light of its broad mandate the staff is still relatively small and needs to strengthen its experience further in some areas, in particular in insurance. Although the FSA operates an inspection-based system, the pressure on its resources suggests it should make greater use of external auditors of financial institutions. Formalization of the arrangements for the exchange of information between the FSA and the Bank of Japan (BoJ) and other regulatory bodies would increase efficient use of specialist skills.

16. **On deposit insurance, staff agrees with the authorities' decision to defer for two years the complete withdrawal of the remaining component of the blanket guarantee earlier scheduled for April 2003.** The authorities have bought time with this decision, which does, however, envisage an indefinite unlimited guarantee of a subset of demand deposits.

17. **The BoJ's lender of last resort facilities appear to work well and cooperation on crisis management issues between the BoJ and the FSA is satisfactory.** Important improvements have been made recently and management of the Resona case seems to have been effective. However, it is not yet clear whether any modification to the framework may be necessary in managing failures to take account of the new partial deposit insurance regime that became effective in April 2002 where confidence factors are likely to be more pronounced and demands for emergency liquidity might well arise more frequently and quickly.

18. **Other key elements of the financial framework appear to be sound.** The efficiency and safety of the payment, clearing, and settlement arrangements in Japan have

been strengthened, including through the implementation of a real-time gross settlement mode in the main system. Overall, the level of transparency with respect to monetary and financial policies is in line with international good practice. There is a strong commitment to transparency, statutes state clearly objectives and responsibilities, and the authorities communicate well. Finally, a preliminary and partial review of the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) framework did not reveal major issues; a full AML/CFT assessment is planned for the fall of 2003. Overall, public debt management practices in Japan are consistent with the existing international practices, although there is some room to strengthen the risk management framework.

II. Macroeconomic Environment and Financial Structure

A. Recent Macroeconomic Developments

19. **Since the bursting of the asset price bubble in 1990/91, the Japanese economy has entered into a prolonged slowdown.** During 1991–2002, growth rates averaged only 1 percent per annum, compared to 4 percent per annum in the 1980s. Unemployment and corporate bankruptcies have reached post-war record highs as the corporate sector remains saddled with excess capacity and low profitability. Deflation, with its impact on real debt burdens and collateral values, continues unabated. Equity prices and land values remain weak, reflecting the sluggish economy and overhang in the real estate market. In 2002, Japan recovered from its deepest recession in four decades, but growth slowed during the year and the economy is expected to remain broadly flat in 2003.

20. **Macroeconomic policies have had a limited effect in bringing about sustained recovery.** Despite a series of fiscal stimulus packages, unprecedented monetary easing, and deregulation initiatives, the economy has failed to break out of its slump. Increases in base money have not fed into the broader monetary aggregates or stopped the five year decline in bank lending. Continued fiscal deficits have fed a rapidly growing government debt which is now the highest among industrial countries and have raised concerns over the sustainability of fiscal policy.

21. **Japan's favorable external position suggests that the risk of an external crisis is low.** With official reserves at around US$530 billion (as of May 2003), Japan has the highest level of official reserves in the world, is a major net external creditor, and enjoys sizable current account surpluses.

B. Financial Structure

22. **The Japanese financial system is bank centered.** The banking sector is fragmented despite many years of deregulation and its profitability is low.[2] The major banks, including the trust banks, account for about one quarter of total financial system assets. There are many

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[2] The financial system is described in more detail in Appendix II.

regional banks and a variety of smaller, specialized players in the banking market. Foreign banks in Japan, although numerous, have a relatively small presence. There is extensive cross-shareholding and other relationship-based shareholding within the financial sector and between financial and nonfinancial institutions.

23. **The public sector plays a much larger role in financial intermediation than in other major OECD countries.** The Japan Post—the largest deposit taker in the world—takes deposits, and offers payment services and life insurance products in addition to mailing services. The Fiscal Investment and Loan Program (FILP) has traditionally provided a mechanism for the funds collected by the former Postal Services Agency (PSA), together with other sources of funds such as pension funds, to be channeled to the public sector on a long-term basis. Other government financial institutions have a market share of 20–40 percent in various lending markets.

24. **The insurance sector is large and systemically important.** Japanese insurance companies have in the past played a major role in funneling household savings to the industry sector and the government, and roughly 95 percent of households have life insurance policies. One of the largest single insurance businesses is the Postal Insurance System ("Kampo") controlled by the Japan Post. The insurance industry has been shrinking for the past two decades reflecting reductions in investment income, the sharp fall in the values of securities, and demographic trends.

Japan: Financial Soundness Indicators for the Insurance Sector, 1998-2002

(In percent, end of March, unless noted otherwise)

	1998	1999	2000	2001	2002
Solvency ratio 1/					
Life insurance companies	705.9	692.8	819.0	712.8	671.9
Non-life insurance companies	908.1	1,385.7	1,290.8	999.9	934.6
Nominal growth rate of gross premium income					
Life insurance companies	3.4	-5.0	-4.3	-2.4	…
Non-life insurance companies	-1.3	-4.8	-0.7	0.6	…
Net pre-tax earning as percent of total assets					
Life insurance companies	0.8	0.1	0.5	0.3	0.2
Non-life insurance companies	1.2	0.9	0.5	0.5	-0.8

Sources: Bank of Japan "Financial and Economic Statistics," Life Insurance Association of Japan, and FSA websites and internal data.

1/ There were 43 Life insurance companies and 59 Non-life insurance companies as of September 2002. The solvency ratio is calculated by dividing the total solvency margin by half of the total risk equivalent amount. The total solvency margin includes core capital, reserves with a capital nature, valuation gains and losses on marketable securities and real estate, subordinated loans, and future profits. The total amount is a function including insurance risk, assumed interest rate risk, investment risk, and operational risk, which in turn are calculated using fixed prudential risk weights.

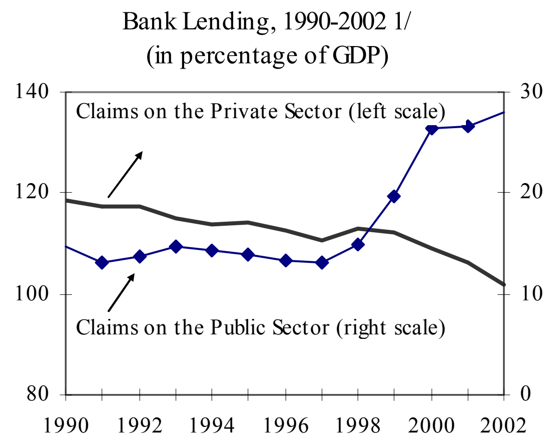
C. Macroeconomic Links to Financial Stability

25. **The prolonged economic slowdown has weakened the banking system.** The sluggish economy has constrained bank profitability and exacerbated the bad loan problem. In addition, deflation has had the crippling effect of magnifying real debt burdens, raising corporate bankruptcies, and undermining collateral values. Although Japanese banks have disposed of more than ¥90 trillion in nonperforming loans (16 percent of GDP) since 1992, official NPLs, gross of provisions, still account for over 8 percent of outstanding loans (as of September 2002) as new problem loans continue to emerge. Under these conditions, banks have faced difficulties in raising equity capital at affordable rates (although the major banks raised about ¥2 trillion, mainly in preferred shares, early in 2003) and in raising profits to offset their large credit costs.

26. **Although the abundance of liquidity provided by the BoJ has helped to stabilize the banking system, low nominal interest rates have also had the effect of making it easier for banks to delay recognizing problem loans.** The BoJ's quantitative easing policy and continued deflation have pushed down rates along the yield curve to near-historic lows. Since loan classification is based on the nominal capacity to service debt, low nominal interest rates have made it easier for banks to delay taking action against problem borrowers who are able to make interest payments despite being on the verge of bankruptcy. The flattening of the yield curve has also made it difficult for banks to raise profits through maturity transformation. Despite the exit of a significant number of banks over the past few years, the abundance of liquidity and low funding costs have also allowed many weak banks to continue operating and held back the profitability and consolidation of the sector.

27. **Banking sector weaknesses have, in turn, held back prospects for a sustained recovery and limited the effectiveness of macroeconomic policies.** Banks have limited capacity to accept risk and have been responding to pressure from the market by curtailing loans and switching to risk-free assets such as Japanese government bonds (JGBs) and cash reserves. The impaired banking system and debt overhang of the corporate sector have also undermined the effectiveness of monetary policy by hampering its transmission. Despite expanding liquidity bank lending continues to decline, reflecting in part weak demand from a corporate sector that is still re-adjusting its balance sheets and the unwillingness of banks to take on more risk.

Bank Lending, 1990-2002 1/
(in percentage of GDP)



Source: IFS.
1/ Banks comprise commercial banks and other financial institutions that accept transferable deposits.

28. **The lack of progress in bank reform has also delayed corporate restructuring, since banks, as the major holder of corporate debt, are unable to push for meaningful restructuring.** Banks lack the capital to write-down problem loans and thus face little incentive to liquidate nonviable firms or enter into workout agreements with their distressed borrowers. Instead these assets remain with the banks where they stand little chance of recovery. The continued presence of these nonviable firms has held back prospects for a recovery by prolonging the problem of excess capacity and adding to deflationary pressures.

III. Banking

29. **The banking system is exposed to significant credit and market risks.** The fragility of the banking system stems from: (i) continuing asset quality problems including large NPLs, a weak capital base, and exposure to the stock market (the stock problem), and (ii) a lack of underlying profitability (the flow problem) which has prevented the banks from dealing with the asset quality issues and has eroded the system's capital base. Despite the large number of reforms in recent years, the financial system's continued limited capacity to support corporate restructuring and balance sheet adjustments has contributed to slow economic growth which, in turn, has further weakened asset quality.

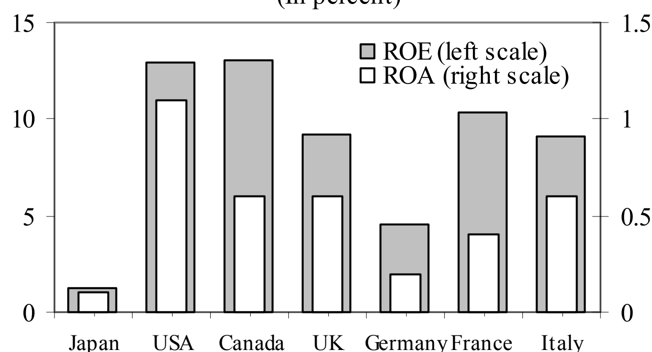
Japan: Nonperforming Loans, 1997-2002
(In percent, end-March, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	Sept. 2002
Nonperforming loans to total loans 1/	3.7	5.4	5.8	6.1	6.6	8.9	8.6
City banks	3.6	4.8	5.2	5.0	5.4	9.4	8.7
Trust banks	6.0	8.4	11.0	8.7	7.5	9.5	8.6
Long-term credit banks	5.4	10.0	9.1	9.0	10.0	9.6	14.9
Regional banks	2.4	3.7	4.9	5.6	7.0	7.7	8.1
Regional banks II	3.8	5.3	5.5	6.7	8.2	9.0	9.0

Source: FSA.
1/ Nonperforming loans are defined as "risk management loans," which include loans to borrowers in legal bankruptcy, past due loans by 3 months or more, and restructured loans.

30. **The weakness of the banking sector is reflected in a variety of market and other indicators.** Bank equity performance has been poor, and the cost of other forms of bank capital is high. Bank liabilities may have relatively high ratings (long-term deposits are, on average, rated by Moody's at A3-Baa1) but this is mainly attributable to the existence of the safety net. The average of Moody's financial strength ratings for Japanese banks is between D- and E+, with other G-7 banking systems having average ratings in the A- to C+ range. Bank profitability and the rate of return on equity are considerably lower than in other G-7 countries.

Commercial Banks: Return on Equity and Assets, 2001 1/
(In percent)

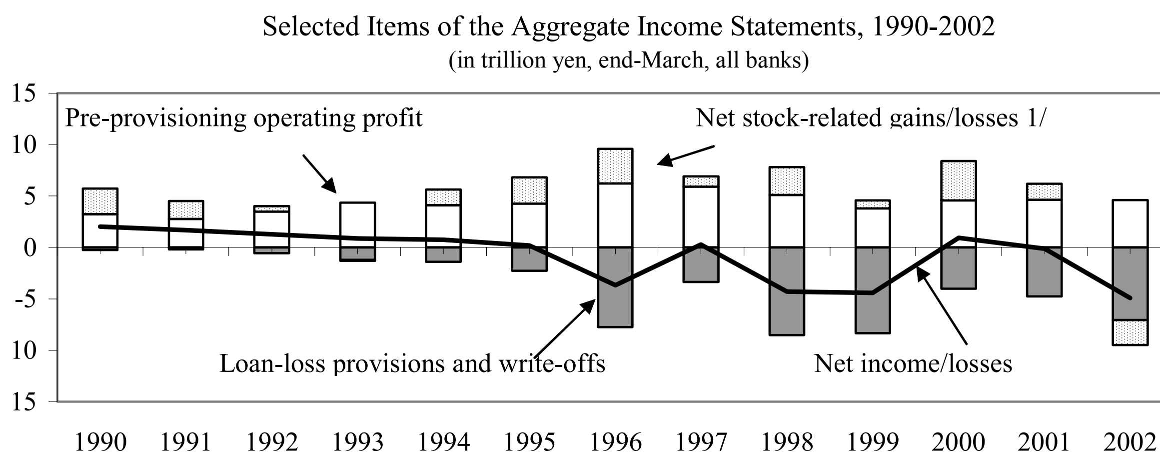


Source: National authorities, EDSS and Bankscope.
1/ Data year ending March 2001 for Japan.

31. **The inherent unprofitability of banks may well persist as long as the economy remains stagnant.** The continuing low level of profitability is due to the weakness of the corporate sector (particularly that part dependent on bank finance), the small net interest margins, competition from the public sector, the large number of competing institutions, and weaknesses in governance. Excessive costs do not appear to be a major factor. The banks argue, as they have often in the past, that they are now at the point where they can begin to raise the yield on their assets. Although some banks have been able to improve their return

on equity by shifting from corporate to personal borrowing, this cannot be the solution for the system as a whole. It is therefore unlikely that spreads will widen and profitability improve until the economy attains sustainable growth.

Selected Items of the Aggregate Income Statements, 1990-2002
(in trillion yen, end-March, all banks)



Source: BoJ Website.
1/ Unrealized stock gains/losses were included after March 2001, reflecting a change in accounting rules.

A. Asset Quality

32. **Asset quality deterioration is not yet fully recognized in the banks' assessment process, as shown by FSA examinations.** The FSA acknowledges that refinements in NPL reporting are a continuous process of educating banks. The FSA maintains that progress can be seen in the narrowing gap between the banks' and the FSA's assessments. Staff's judgment is that some banks have further to go than others, but it is helpful that the FSA has begun to harmonize classification of large borrowers across banks in 2003. The introduction of the discounted cash flow approach to "special attention" loans to large borrowers in March 2003 is a step in the right direction. However, there is room for further improvements in NPL recognition on the part of some of the smaller banks.

33. **Debt service delinquencies do not provide effective early warning of NPL problems and the need for further provisioning.** Low nominal interest rates allow even nearly insolvent borrowers to service their debts with minimal cash flow (Box 3). BoJ research suggests that provisions and write-offs are likely to continue to average some one percent of risk assets a year, a figure that is large compared with pre-bubble experience and with current pre-provisioning profits, but not large compared with credit costs in other major countries.[3] The BoJ cited the evidence that as there were "not a few cases in which

[3] See Bank of Japan, "Japan's Nonperforming Loan Problem," released on October 11, 2002; later published in the Bank of Japan Quarterly Bulletin, November 2002.

Box 3. The Impact of Low Nominal Interest Rates on the Banking System and Financial Markets

Although low nominal interest rates have had the important benefit of stabilizing the financial system and preventing an acceleration of deflation, they have also had some side-effects on the banking system. Persistent deflation, the sluggish economy, and unprecedented monetary easing by the BoJ have helped drive down interest rates to historic lows. Low nominal interest rates are the necessary outcome of an aggressive monetary policy geared towards ending deflation and preserving financial stability. The alternative of high nominal interest rates in a weak economy would have severe negative consequences for the banking system and the economy in general. However, in addition to these benefits, low nominal interest rates have also had some side effects on the banking system and financial markets which are outlined below.

Low nominal interest rates have undermined the usefulness of the term "nonperforming loan" in detecting financial distress by easing the financing constraint on borrowers. Loan classification in Japan, as in other countries, is mainly based upon the borrower servicing its debt. However, with nominal interest rates so low, many companies with minimal cash flow are able to service their debt despite being close to insolvency. Thus, official NPL figures may not cover these so called "impaired" loans, which may be performing in the technical sense but whose repayment capacity is in doubt. To ensure that creditors take action against these problem borrowers, strong supervisory oversight and regulatory pressure are needed.

Although low nominal interest rates have allowed viable companies to restructure their balance sheets at lower cost, they have also delayed the exit of nonviable firms. Low nominal interest rates have allowed healthy and distressed but viable companies to refinance and invest at lower costs. Although deflation increases the real burden of debt, ample liquidity and low funding costs have reduced pressures on nonviable firms to exit. The presence of these nonviable firms hurts the restructuring prospects of healthy firms by adding to excess capacity and delaying the reallocation of capital and labor to more productive uses.

The flattening of the yield curve has made it more difficult for banks and insurers to raise their core profitability. BoJ's quantitative easing policy and continued deflation have pushed down rates along the yield curve, particularly at the long-end. With the 5-year rate now at about 0.4 percent and the 10-year rate at around 1 percent, banks can make little profit out of maturity transformation. Low interest rates have contributed to a compression of credit spreads making it difficult for banks to raise their net interest margins. Since 1995, net interest margins on domestic bank lending have remained fairly flat. Since banks typically price their credit risk off risk-free JGB yields, it has become increasingly difficult to raise net interest margins now that deposit rates have nearly reached their floor. Further development of the markets for risky assets, such as low-rated corporate bonds, and a shift away from real estate-backed loans would help banks to better price their risky lending, but this will take time.

Low nominal interest rates have also dampened activity in the interbank call market. The outstanding amount of overnight call money fell to ¥15 trillion in January 2003, down from almost ¥40 trillion in 1997. Facing miniscule returns, banks have largely bypassed the overnight call market and instead have placed their excess reserves either with the BoJ or resorted to bilateral dealings. For example, assuming an overnight uncollateralized call rate of 0.001 percent, a ¥3.5 billion transaction would earn a mere ¥100. As a result, the interbank market has become thin, and the BoJ has emerged as one of the main suppliers of liquidity. The decline in activity has also reduced turnover in other related markets such as for interest-rate futures.

With long-term yields still at low levels, interest rate risks have increased. Banks face large interest rate risk exposure to JGBs, including through their derivatives position. Their exposure has increased significantly as banks have accelerated their purchases of JGBs, which do not require capital to be set aside. As a share of total assets, banks have increased their holdings of JGBs and local government bonds to 12 percent in FY2001, up from 6 percent in FY1998. Although banks have benefited from the decline in nominal interest rates, it has raised their exposure to the almost one-way interest rate risk of yields turning up.

Low nominal interest rates have lowered the franchise value of retail banking and slowed the process of consolidation. With deposit rates near the floor, banks have been unable to bid at below market rates for deposits. Moreover, with the interest rate in the interbank market below the deposit insurance premium, banks have little incentive to expand their deposit base by, for example, acquiring other banks, which hampers the needed consolidation of the banking system.

additional losses unfold in the process of selling loan assets....the current amount of provisioning is unlikely to cover the reduced economic value of NPL."

34. **An additional problem has been the lack of incentives for banks to deal with their problem assets once provisioned.** In some cases banks are reportedly reluctant to sell collateral (partly because funding costs are so low—see Box 3) or otherwise restructure defaulting borrowers. Meanwhile, the problems of borrowers are left unaddressed. However, the government has recently begun to exert pressure on banks to finally "dispose" of these assets by putting the borrowers into insolvency proceedings, restructuring them, or selling the written down claims to the market or to the RCC. The FY 2002 results of major banks indicate that they are on track to meet the target of halving NPL ratios by end-March 2005.

35. **Provisioning is expected to improve as the FSA now recommends that banks base loan valuation on the cash flow borrowers will generate.** The cash flow approach means that banks must establish what the borrower could pay (the economic value as the BoJ puts it) and then agree a new contract and provision down to its net present value. More aggressive provisioning would clearly pay dividends, both in improving the quality of the banks' balance sheets, as well as accelerating the pace of corporate restructuring. The BoJ reported in 2002 that some banks were beginning to improve their ability to recognize quality deterioration quicker. The "special inspection" process designed to ensure banks recognize early deterioration in borrowers' condition has clearly helped as reflected in the higher provisioning levels for "needs special attention" borrowers of major banks in FY 2002.

36. **Bank work-out subsidiaries staffed with the appropriate expertise could improve the quality of bank asset portfolios and enhance corporate restructuring.** Work-out subsidiaries could be sold or merged with a similar entity from another bank. There would be no initial effect on the capital position of the banks as these subsidiaries would be fully consolidated. However, banks might subsequently sell a partial or complete interest in such a subsidiary or issue shares in the subsidiary to their own shareholders. Some of the major banks have already established such units, sometimes as joint ventures with external providers of capital and expertise.

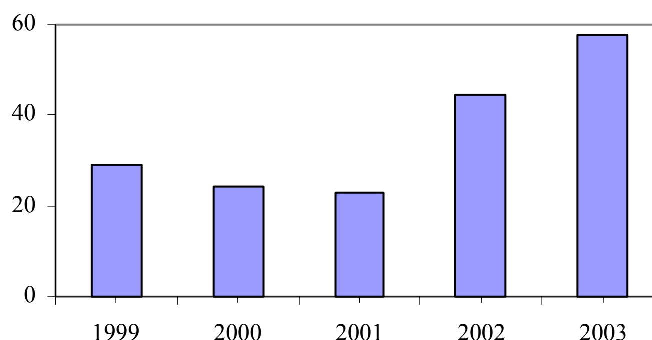
37. **The asset side of the banks' balance sheet is also vulnerable as a result of the large share of quoted equity securities.** Until recently these provided a cushion to the book value of capital insofar as their market value was in excess of book value. That has ceased to be the case and continued declines in the market value of these holdings, which now have to be marked to market, flow straight through to the equity account. The banks are taking steps to reduce their holdings and are required to reduce them further to no more than Tier-1 capital by September 2004. The BoJ's program to buy up to ¥3 trillion of these holdings at market prices, but off the market, is helping banks meet the FSA's required limits, but will only marginally reduce the total exposure to the equity market. An earlier government scheme appears to have been much less used although there were other drawbacks that do not

apply to the BoJ scheme.[4] The major banks have used these arrangements and market sales to make substantial progress in reducing their exposure to the equity market. On average the major banks have now reached the target level already. However, that is still an unusually large exposure for a bank to have to the equity market.

B. Bank Capital

38. **Deferred tax assets (DTAs) now represent about half of the major banks' Tier-1 capital.**[5] Deferred tax assets are credits against taxes on future taxable income. Deferred tax assets arise partly because the tax authorities do not recognize some provisions as expenses. However, as banks have been paying little taxes on their income for several years, the bulk of outstanding deferred tax assets are due to losses carried forward. In essence, therefore, banks are borrowing from expected future profits and subtracting only a part of their losses from capital. While these intangible assets have a value, they are only usable to the extent that the bank makes profits. They are not available to meet losses in the event of the bank failing, one of the prime characteristics of bank capital.

Deferred Tax Assets to Tier 1 Capital 1/
(in percentage, end of March)



Sources: Bank of Japan and Fitch Ratings.
1/ Data is for 13 major banks until 2002 and for 7 major banks in 2003.

39. **On this basis, staff recommends limits on the inclusion of deferred tax assets in regulatory bank capital.** Other intangible assets, such as goodwill, are normally deducted from capital by regulators. In the United States, the only other Basel Committee member country where the difference between taxable income and income reported in financial statements is large, the regulators limit deferred tax assets to the lesser of 10 percent of Tier-1 capital or one year's profits. Staff proposes that a similar approach be adopted in Japan.

40. **Banks are tapping the capital market but have rarely been able to raise ordinary shareholders' funds.** Except in one case, new issues by the banks have mostly been of

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[4] The scheme set up earlier for sales to a government-supported Banks' Shareholdings Purchase Corporation required banks to invest 8 percent of the value of the equities sold in subordinated debt of the Corporation.

[5] The creation and maintenance of deferred tax asset balances is subject to accounting rules established by the Japanese Institute of Certified Public Accountants (JICPA), which limit balances to anticipated future profits over five years. The extent companies make use of these arrangements is scrutinized by external auditors.

preferred securities and other forms of interest bearing securities. They are treated as Tier-1 capital for regulatory purposes, and often sold to insurance companies and other financial institutions anxious to pick up the higher yields offered on such paper. These cross shareholdings do not add much to the strength of the system as a whole. Japanese banks are not alone in resorting to the markets for such instruments, but in doing so they are unable to generate ordinary shareholders' funds as well. A wider ownership of bank equity will require greater profitability than over the last decade.

41. **Staff believes that the specific and general provisioning regulations overstate bank capital.** Provisions in respect of category II loans, that is "needs attention" and "needs special attention" loans, which are treated as general provisions, should not be included in Tier-2 capital. These provisions, in fact, are largely raised in respect of specific assets whose quality is in some doubt. The mission's view is that this practice is not consistent with the Basel Capital Accord.

42. **Stress test estimates suggest that banking institutions have substantial equity and interest rate exposures.** After protracted discussions, the authorities indicated that they would not be in a position to share potential stress exposures using supervisory data. Thus, staff examined the impact of selected stress scenarios on a sample of city, regional, and credit cooperative central banks, using data from 2002 annual reports, the latest available (Box 4 presents a summary of the stress test results; Appendix III explains the methodology and certain limitations of the tests).[6] A combination of these interest rate and equity stresses could challenge the risk-bearing capacity in many of these institutions. Under a stress scenario that mirrors recent loan loss experience, credit risk is significant for banking institutions which are weakly capitalized. Regional banks are better capitalized relative to the combined market risk stresses, but are nonetheless highly exposed to credit risks. Measured by the loss-bearing capacity of shareholders' equity, the Japanese banking system is undercapitalized relative to the interest rate, equity price, and credit risks in the system. Measures of risk bearing capacities are further diminished when the limited loss-bearing capacity of deferred tax assets is recognized. The results highlight the importance of government safety nets for maintaining investors' confidence and the need for strengthening the capital base of the banks.

C. Bank Recapitalization

43. **The case for strengthening the capital base of the banking system is thus clear.** Once banks are fully provisioned and the recommended adjustments to capital are made, it would be apparent that minimum requirements would not, in many cases, be met. For example, if deferred tax assets were to be deducted from the capital for major banks, then their average Tier-1 ratio as of March 2003 would fall from 5 percent to around 2 percent.[7] In

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[6] The analysis will be updated on the basis of March 2003 data and provided to the Board.

[7] Since March 2003, there has been an increase in Resona's capital (see Box 5).

Box 4. Summary of IMF Staff Stress Test Results

The stress tests sample includes 7 city bank financial groups, 21 regional banks, 2 central banks of credit cooperative financial institutions, and 10 life insurance companies. It represents 56 percent of the total assets of banks and cooperative financial institutions and 86 percent of the assets of the life insurance industry. Staff estimated stress test exposures using the latest publicly available annual report data (end-March 2002). The market risk stress shocks are based on a 20 percent decline in equity prices and a 100 basis points increase in yields. The test includes a credit risk shock in which banks suffer losses equal to 3 percent of the book value of their loan portfolios. Insurers credit losses are assumed to be 1.5 percent in respect of the higher quality of their credit portfolios. (See Appendix III for details.)

Loss bearing capacities are measured according to an institution's ability to absorb losses against shareholder equity value measured both gross and net of deferred tax assets (DTAs). For insurance companies, stress losses are measured against shareholders' equity and selected reserve account balances.

The financial sector group average stress test results show that these single market stress events consume a significant portion of the financial system's risk bearing capacity. End-March 2002 data suggest that, relative to their capital, city banks and insurance companies have the largest equity exposures while the cooperative institutions' central banks have the largest interest rate risk exposures. Credit risks are less important for the life insurance sector. Foreign exchange exposures are unlikely to be a large direct risk source for these institutions but annual report data do not provide the detail necessary to confirm this conjecture.

Group Average Stress Test Results, end-March 2002

	shock	city banks	cooperative central banks	regional banks	life insurance /1
	Loss measured as a percentage of shareholder equity				
equity stress	20% decline in prices	37%	3%	11%	58%
interest rate stress	100 bps increase in yields	17%	49%	16%	19%
credit risk stress	3% credit loss on loan book	54%	38%	41%	9%
	Loss measured as a percentage of shareholder equity net of DTA				
equity stress	20% decline in prices	102%	3%	15%	86%
interest rate stress	100 bps increase in yields	43%	51%	22%	28%
credit risk stress	3% credit loss on loan book	140%	39%	63%	13%

Source: 2002 annual report data and IMF staff estimates.

1/ Insurance shareholder equity includes selected reserve account balances; credit risk shock is 1.5 percent for life insurers.

Figure 1: Combined Market Stress Test Results for City and Cooperative Central Banks

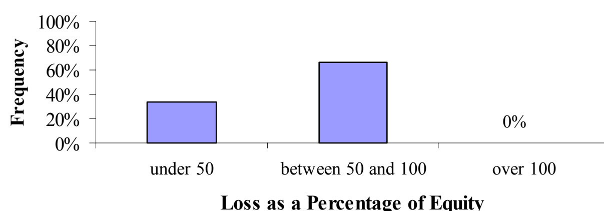
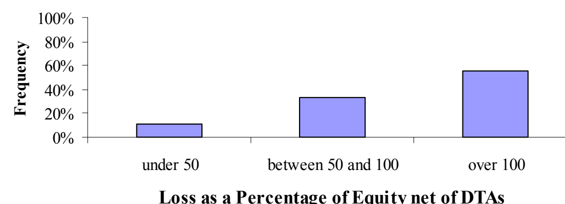


Figure 2: Combined Market Stress Test Results for City and Cooperative Central Banks



The distributional results from the combined market risk scenario (share prices decline by 20 percent and interest rates rise by 1 percent) are shown in Figures 1–4. A combination of market stresses may challenge the risk bearing capacity of many institutions (Figure 1) and the capitalization levels of the city banks appear significantly weaker if the data are corrected for the limited risk-bearing capacity of DTAs (Figure 2). Regional banks (Figure 3) are less vulnerable to these market stresses. Stress test estimates suggest that many life insurance companies (Figure 4) have significant exposures to equity and interest rate risk relative to their capital and reserve assets that are available to buffer losses.

Figure 3: Combined Market Stress Test Results for Regional Banks

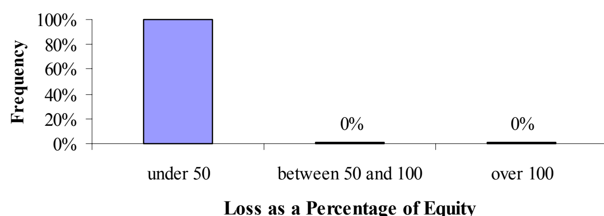
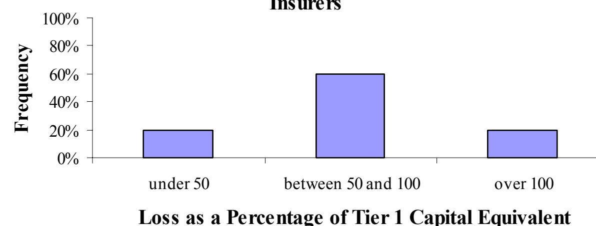


Figure 4: Combined Market Stress Test Results for Insurers



A combination of market and credit risk stresses could deplete book shareholder equity in a large number of banking institutions and test the required solvency margin buffers of some insurers. While bank operating profits supplement banks' capital buffers, operating margins are thin in the current environment. The results highlight the importance of government safety nets in sustaining depositors' and policy holders' confidence.

accordance with the FSA's rules, the prompt corrective action procedures would be triggered and the FSA would call for additional capital. It will likely be difficult to raise such funds from the market given the present state of profitability.

44. **Staff recommends that the government develop a plan to recapitalize the banking sector expeditiously.** Such a plan would have possible short-run costs in the form of an adverse impact on the economy and the use of public funds. However, a recapitalized banking system would enable Japan to break out of the downward spiral described in Appendix II. Strengthened banks with invigorated managements could both restructure and modernize the banking system and drive the corporate restructuring process. The result would be a strengthened financial system that can do without public assistance and make a major contribution to macroeconomic stability.

45. **Such a plan should be publicly announced and be on offer to all systemically important banks whose capital ratios fall below 8 percent.** All of the elements of the scheme should be fully transparent to preclude the influence of any vested interests. As a result of actions to increase provisions and to limit deferred tax assets, those systemically important banks that are unable to raise sufficient capital in the market within a prescribed time limit should be recapitalized with public funds to at least 8 percent. If Tier-1 capital is below 4 percent, the government would convert its existing holdings of preferred shares into equity and subscribe additional equity to bring the banks' Tier-1 ratio up to 4 percent, thereby diluting existing shareholders' stake. Additional injections to bring the total ratio to at least 8 percent could take the form of Tier-2 capital.[8] The scheme should also mandate the establishment of asset management companies by those banks that have not already done so. In essence the plan would be an extension of the prompt corrective action framework in cases where banks are unable to access the private market.

46. **The conditions attached to government recapitalization should include profitability targets to which the management would be held accountable.** Other elements of conditionality could include a requirement that banks adopt the corporate governance reforms that have been suggested recently and that are consistent with the Basel committee's corporate governance guidelines. Such a plan would also require a governance framework so that the DIC and the RCC could exercise the government's role as a principal shareholder in a transparent and effective manner, e.g., in the selection of the directors which the government would be entitled to appoint on the basis of its shareholding, which in some cases might be a majority. Encouragingly, this appears to be the process that the government has embarked on in the Resona case (Box 5). In addition, it would be crucial to give bank management a clear mandate to restructure the banks' operations in preparation for reprivatization, protect it from outside pressures, and hold managers accountable for their performance.

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[8] In practice banks generally prefer to operate with a margin of 1 or 2 percentage points above the statutory minimum ratio.

Box 5. Government Rescue of Resona Bank

On May 17, 2003, the government announced a recapitalization with public funds of the Resona Group. The group is the smallest and the last to be formed of the five major banking groups. The announcement stated that the Financial System Management Council had agreed, and the Prime Minster had ordered under Article 102 of the Deposit Insurance Law, that the Resona Group be recapitalized by the Deposit Insurance Corporation (DIC) to bring its capital adequacy ratio well in excess of 10 percent. Article 102 provides that if the failure of a financial institution poses a serious threat to the financial system, the Prime Minister can, on the advice of the Council, provide financial assistance. This is the first time that the provision, introduced in 2000, has been invoked. At the same time, the BoJ agreed to provide liquidity support in the event that the group might experience funding difficulty. In the event this proved unnecessary; the government's actions successfully forestalled any liquidity pressures.

The government's intervention was triggered by the auditors' refusal to sign off on the initial accounts, insisting that the amount of DTA in the balance sheet was overstated. On the basis of the revised accounts, the group's capital ratio fell to 3.8 percent, below the minimum of 4 percent applied to domestic banks. (In September 2002, the ratio had been 7.8 percent.) This would have required the issue of an order under the "prompt corrective action" (PCA) procedure. The government believed that this would have led to a loss of confidence in the group, hence its decision to invoke Article 102 at the same time as issuing a PCA order.

Resona, when making formal application for the funds, also submitted a business revitalization plan involving a substantial cut in salaries and the departure of some 70 senior management. On June 10, the FSA accepted the application. On June 27, the shareholders at their annual meeting approved the reduction in capital necessary to cover the losses arising in the financial statements for the year ended March 2003, as well as substantial changes to the board of directors. The shareholders elected a new independent chairman and non-executive directors who will comprise a majority of the board. The new capital (mainly in voting preference shares but also including ¥0.3 trillion of ordinary shares) amounts to approximately ¥2 trillion and gives the government more than 70 percent of the votes.

The group's new business plans must be published and the group will be required to make periodic progress reports on their implementation. Although the FSA did not commission any new examination of the bank's assets, as they had recently carried out a special examination and the accounts had been audited, the new Board has now commissioned from a separate audit firm a new assessment of the group's assets, on the basis of which the new management will update its own business plans.

47. **It is advisable not to include conditions which are not conducive to increasing the recapitalized banks' profitability.** In the past, banks have been required to meet specific targets for lending to SMEs. This, however, tends to put pressure on banks' margins, increases their risk profile, and distorts the credit allocation process; if the government wishes to facilitate access to credit by this or any other group of borrowers it should do so by other means.

D. Bank Governance and Capital Adequacy

48. **Improvements in governance would enhance the incentives for bank management.** Of particular importance for financial institutions would be the adoption of a requirement for banks to appoint well-qualified outside directors, for a board audit committee to consist solely of outside directors, or at least have a majority and the chairman drawn from

that group. The audit committee should be responsible for recommending the appointment of the external auditor or independent accounting firm, and the internal auditor of the bank should report to the audit committee.

49. **Staff is of the view that all banks should be subject to the 8 percent minimum capital requirement.** Banks that do not have overseas offices ("domestic banks") are subject to a capital adequacy ratio of 4 percent compared to 8 percent for "internationally active" banks. The authorities argue that the Basel Capital Accord only applies to internationally active banks, a term not defined in the agreement. They agree with staff that domestic business is no less risky, but feel that the system is not yet robust enough to change the arrangements. They also point out that, on average, all groups of banks exceed the 8 percent minimum, although there are individual banks that fall below it. Staff believes that the minimum capital requirement for domestic banks should be raised to 8 percent, and that this change could be phased in over a period of years to minimize disruption.

E. The Market for Distressed Debt

50. **The RCC could play a role in developing the market for distressed debt by purchasing impaired assets from banks and transferring them quickly to the private sector.** The supply of distressed debt is constrained by the reluctance of banks to sell their NPLs. Possible reasons include: underprovisioning by banks, which could lead to gaps in pricing; insufficient capital to absorb further losses; banks' close relationships with their borrowers; creditor coordination difficulties; and the low carry costs of these loans with the fall in interest rates. Like asset management companies in other countries, the RCC can facilitate the transfer of these assets by purchasing company debt from various creditors and repackaging them for quick sales either through auctions or as a securitized asset. As much as possible though, the RCC should avoid crowding out the private sector in purchasing NPLs from the banks. The RCC's mandate to purchase NPLs at realistic and fair market prices is appropriate since it promotes transparency and creates the right incentives for the RCC and banks to restructure loans or seek out bankruptcy procedures.

51. **More recently, the government has created the IRCJ to help promote the restructuring of viable but distressed firms.** The IRCJ began operations in June 2003 and plans to purchase distressed loans from non-main banks and, in conjunction with the main bank, help companies restructure. The IRCJ will purchase loans at fair market value taking into account an assessment of the company's rehabilitation program. The IRCJ could play a useful role in restructuring, but to do so, it would be important that the IRCJ operate free from political interference aimed at keeping nonviable firms alive. To lessen this risk, the IRCJ should limit as much as possible the period between the purchase and sale of loans and be subject to strict rules on the transparency of its operations, including on its progress in recovering public funds.

IV. PUBLIC SECTOR FINANCIAL INTERMEDIATION AND OTHER FINANCIAL INSTITUTIONS

A. Public Sector Financial Institutions

52. **The long-term involvement of the public sector in financial intermediation has held back the development of the financial system by undermining market competition through special privileges.** The Japan Post, which offers deposits, a payment system, and life insurance products does not participate in the deposit insurance system and benefits from an explicit government guarantee. The Government Financial Institutions (GFIs), which offer long-term loans with low fixed interest rates, also benefit from explicit and implicit government guarantees and face favorable regulatory and tax regimes. The Japan Post and most GFIs are not subject to key prudential regulations as in the private sector, do not pay dividends to the government, and are exempt from most taxes. However, the special privileges of the Japan Post are partially offset by the social obligation to maintain a nationwide network—including in unprofitable areas. They are not required to earn a return on their capital employed, and indeed the postal savings account suffered substantial losses in recent years.

53. **The operations of GFIs have also been an impediment to the development of the securities market.** In particular, direct lending by the Government Housing Loan Corporation (GHLC) has impeded the development of an active mortgage-backed securities market. The Development Bank of Japan and the Japan Bank for International Corporation (JBIC) also extend loans to listed large companies capable of procuring funds from the corporate bond market.

54. **Given its dominance as a deposit taker and a JGB investor, any reform of the Japan Post poses a difficult challenge which calls, as a first step, for gradually downsizing its operations to minimize disruption.** Downsizing could be achieved by phasing in a reduction of the maximum limit on its products and by subjecting the Japan Post to the same regulatory and tax treatment as those faced by private financial institutions. Once downsized, the Japan Post could either be refocused or privatized. If refocused, the institution could stop accepting new accounts in local areas where it competes directly with the private sector and limit itself to providing basic financial services to small depositors in local areas without easy access to private financial institutions. Use of its comprehensive branch network could then be offered to the private sector for a fee.

B. Insurance Sector

55. **Life insurance companies and their actuaries should establish appropriate policy reserves for all policies taking into account current investment returns and other conditions.** The FSA should not permit the current practice of discounting policy reserves using interest assumptions that exceed current actual investment returns. Instead, insurers should be encouraged to revalue their policy liabilities to account for currently lower

investment returns.[9] Further, insurers should be required to set aside deficiency reserves against known losses on investment returns.

56. **Quantitative analyses suggest that many life insurance companies have large exposures to equity market risk and, to a lesser extent, interest rate risk relative to their capital.** A number of life insurance companies would have difficulties in absorbing a combination of market stresses with their available core capital and reserve accounts. While life insurers' solvency margin buffers are supplemented by their operating profits, they are compromised by the DTAs in many life insurers, which are of limited loss-bearing capacity.

57. **The solvency ratios computed using the tests prescribed by the FSA do not convey an accurate impression of financial health and should be strengthened.** Companies' own assessment of their capital requirements using internal formulae show that they do not possess the substantial margins that are indicated by the FSA formula. The FSA should review its formula taking into account the risk-based capital formulae employed by the companies and make adjustments as necessary, particularly in the areas of risk weights used to calculate risk amounts and the liabilities items that can be qualified as solvency margin.

58. **The FSA should take steps to limit insurance company participation in derivative markets.** Since insurance companies accept the transfer of risks from their policyholders, they should not aggravate their risk position through speculation in derivatives trading. Supervisors in many countries have endorsed the use of derivatives for purposes of hedging risks of all types. However, it is not appropriate for an insurance company to trade in derivatives merely to obtain speculative profits. The FSA should enforce some type of exposure limits for derivatives until their capacities for assessing the insurance companies' internal risk control and management systems are adequately developed.

59. **Nonlife insurance companies' heavy concentration in domestic property and the associated risks require careful monitoring.** A serious natural disaster or string of related disasters could cause considerable damage to the industry both in terms of the expected claim losses to be paid and the likely loss in asset values that could accompany the disaster. The FSA should carefully monitor this aspect of insurance company risk management programs, which will require the services of experienced (re)insurance experts.

C. Pension Funds

60. **Steps to address the limited funding of pension liabilities are needed to restore confidence in the public pension system.** Public pensions are now funded only about 20–

[9] Legislation has recently been passed providing for an out-of-court mechanism to permit insurers to reduce their guaranteed yields with the approval of a high percentage of policyholders before falling into bankruptcy. Granting insurers the flexibility to pursue an out-of-court restructuring is desirable and should be combined with a tightening of the solvency standards to promote a more accurate assessment of their financial conditions.

25 percent, implying a major intergenerational transfer from the current working population to retirees. Non-payment of contributions to the national pension scheme has reached about 25 percent and is rising still, suggesting a loss of faith in the system. Management of public pension fund assets is broadly sound, but there is room for improvement. To restore confidence in the system, funding should be kept under review and liabilities should be evaluated alongside assets, using a range of discount rates. Additional checks and balances should also be introduced to remove the possibility of undue political influence in the development of investment policy. Specifically, it is recommended that an independent professional body be set up and given the task of developing an investment policy for public pension fund assets. The Government Pensions Investment Fund (GPIF) displays a high degree of transparency and has made a significant contribution to corporate governance through its commitment to shareholder rights. Its future status should be clarified, and its operations strengthened, including by hiring more staff with investment experience.

D. Securities Firms

61. **The risks of a systemic crisis emanating from the securities sector appear limited on the basis of available data and measures taken to strengthen supervision and risk controls.** The small share of financial assets held by the securities industry (around 3 percent)—an industry already accustomed to large turnover over the past 5 years—along with the improvements to the payment and settlement systems, and the expansion of the investor safety net suggest that the risks of systemic collapse are lower than they were during the 1997–98 financial crisis. Moreover, supervision both by the FSA and the SESC as well as by the self-regulatory organizations has been improved and a crisis management framework has been put in place. This assessment, however, does not include data on off-balance sheet liabilities. The authorities have argued that with the introduction in FY 2003 of an external audit requirement on the separation of clients' assets and the implementation of a principle-based approach to off-balance sheet transactions, the risks of an unexpected revelation of large off-balance sheet liabilities are small.

V. Financial Markets, Household and Corporate Sectors

A. Financial Markets

62. **Financial markets in Japan have been put under considerable stress from the weak economy, the financial crisis of 1997–98, and the ongoing structural changes taking place in the corporate and financial sectors.** Since financial markets can be both a source of systemic risk as well as a transmission channel for shocks through the financial system, these changes taking place within the system have highlighted the need for careful monitoring of potential systemic risk and vulnerabilities arising from these markets. In the current environment, the key issues concerning financial market stability include:

- **Low short-term interest rates have sharply dampened activity in the interbank call market, making it difficult to observe early signs of distress.** The fall in

activity has raised the need for careful monitoring of participating institutions and for steps to reactivate the market.

- **The relatively small markets for direct financing, such as for corporate bonds and syndicated lending, have left the banking system directly exposed to weaknesses in the corporate sector and vice versa.** Further improvements in corporate governance would help to develop these markets further and facilitate a shift away from relationship-based lending.

- **The ownership of JGBs is relatively concentrated, and the market remains concerned over a possible sharp increase in JGB yields.** As a result, the market has come to rely more upon the BoJ and other large public holders of JGBs to preserve market stability.

63. **Structural changes that had started with the Big Bang in 1996 (Box 1) are likely to continue with important implications for the banking and corporate sectors.** Banks are likely to face greater pressure on the lending side as corporates turn more to direct instruments of financing and on the deposit side as investors' appetite for risk recovers. On the positive side, credit risk pricing is likely to improve as the market for high risk lending expands and new instruments for risk management develop.

B. Household Sector

64. **Japanese households' indebtedness seems to be in line with their ability to pay** (Box 6)**.** Total household wealth declined sharply during the 1990s, reflecting the bursting of the land price bubble and declining personal savings, although compared to other G-7 countries, Japanese households' financial assets are still large. Further, households now have more than half of their financial wealth in currency and deposits. The liquidity of household wealth has reduced their vulnerability to financial distress, so that private sector vulnerability is mainly with the corporations and banks. As Japan moves to a more capital-market oriented economy, households will likely shift more of their assets away from deposits in search of higher risk-adjusted returns.

Japan: Selected Financial Soundness Indicators for the Household Sector, 1997-2001
(In billions of yen, end-December, unless otherwise indicated)

	1997	1998	1999	2000	2001
Disposable income, net (percentage change)	2.0	1.0	-0.6	-1.5	-2.9
Liabilities as percent of gross disposable income	118.3	117.7	117.8	118.6	120.1
Liabilities as percent of net worth	17.2	17.6	17.0	17.1	17.6
Liabilities as percent of financial assets	29.8	29.9	27.7	27.5	27.6
Savings rate	7.8	9.6	9.3	8.2	5.3

Sources: Nomura Research Institute and staff calculations.

C. Corporate Sector

65. **Corporate distress is especially pertinent in the analysis of the systemic vulnerabilities of the financial system of Japan**. The intertwining of corporate distress and the commercial bank NPL problem means that restructuring of one cannot be undertaken without the restructuring of the other. Financial vulnerability in Japan is reflected in the level

Box 6. Is Balance Sheet Adjustment in Japan Complete? Comparisons with other G-7 Countries[1]

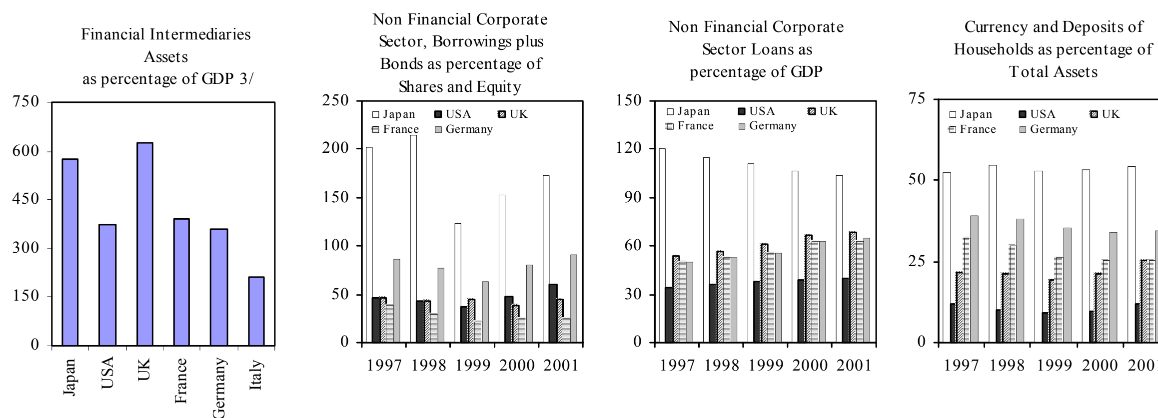
The significant private sector balance sheet adjustments made in the past several years raise the question as to how much further adjustment is required for a reduction in systemic financial vulnerability. Comparisons of the financial structure of Japan with its G-7 counterparts can help clarify this issue. Although there is no reason why financial structures of different countries should be identical, an analysis of the differences between the financial structure of Japan and other G-7 countries can complement microeconomic and other analyses and thus help inform policy conclusions.

The financial sector of Japan is relatively large. The ratio of financial intermediary assets to GDP is the highest of the G-7 countries except for the U.K. The relatively large size of the financial sector in Japan suggests that financial sector stress has important implications for the real sector.

Corporate balance sheet adjustment does appear to be underway but has some way to go before leverage approaches the levels for other G-7 countries. The nonfinancial corporate sector of Japan remains highly leveraged compared to other G-7 countries. The aggregate debt-equity ratio of 175 percent for Japan is almost double that of the next highest country, Germany. In addition, the ratio of corporate bank borrowings to GDP is much higher for Japan compared to other G-7 countries, indicating that the high leveraging of the corporate sector poses relatively greater risk to real activity.

The size of household balance sheets in Japan is in line with that of other G-7 countries but Japanese households are highly risk averse. Household financial assets as a ratio to GDP are comparable to that of other G-7 countries. Japanese households maintain more than half of their assets as currency and deposits, a much higher ratio than in other G-7 countries. The share of assets held as currency and deposits has remained stable in the past five years. The preference of Japanese households to keep their assets in currency and deposits rather than in securities may help explain the relatively limited development of direct sources of corporate financing.[2]

The qualitative and quantitative differences between the financial structure of Japan compared to its G-7 counterparts suggest that the process of balance sheet adjustment may not be complete. These differences demonstrate the importance of a timely and comprehensive policy strategy aimed at alleviating financial stress.



Sources: BoJ, Eurostat, FRB, IFS, National Statistics U.K., and StatCan.

1/ Data for France as of 2000, all other countries 2001. Data for the household and non-financial corporate sector is not available for Canada and Italy.

2/ Philip Davis (IMF WP/01/115) finds evidence that active security markets are beneficial for the stability of corporate financing.

3/ Data for financial intermediaries is not available for Canada.

of bank nonperforming loans and its counterpart, the high leverage and low profitability of large parts of the corporate sector. Important progress has been made in reducing corporate leverage in recent years in Japan. However, this progress has been attained largely by the deleveraging of medium and large firms. Small firms, which have the weakest earnings, still are more highly leveraged than the larger firms.

Japan: Selected Financial Soundness Indicators for the Nonfinancial Corporate Sector, 1998-2002

(In percentage, end-March, unless otherwise indicated)

	1998	1999	2000	2001	2002
Capital Structure					
Debt-equity ratio	4.0	4.2	3.5	2.9	3.0
Large-size firms (capital > 1 billion yen)	2.4	2.3	2.2	2.0	2.1
Medium-size firms (1 billion yen > capital>10 million yen)	6.3	6.6	5.0	3.8	4.1
Small-size firms (capital < 10 million yen)	9.0	10.2	10.4	9.3	11.4
Total corporate debt to GDP	108.6	112.4	100.9	94.4	94.5
Share of short-term debt in total	43.1	39.9	41.8	41.2	42.3
Profitability					
Return on asset (pre-tax)	2.1	1.6	2.1	2.8	2.3
Return on equity (pre-tax)	10.7	8.3	9.5	10.9	8.9
Market-based indicators					
# of bankruptcies per year	17,439	17,497	16,887	18,926	20,052
Bankruptcies liabilities (% of total corporate liabilities)	1.4	1.4	1.1	2.7	…

Sources: Nomura Research Insititute, Teikoku Databank, and staff calculations.

66. **The traditional corporate governance system in Japan impeded restructuring and balance sheet adjustment.** Shareholders had substantial power over boards of directors on paper, but did not have effective control due to obstacles to their involvement. Boards combined the executive and shareholder functions but were often ineffective owing to dominance by insiders. This structure may have worked well in the past but it now slows the pace of restructuring, and thus prevents the amelioration of systemic risk and efficient resource allocation. Enhanced market incentives for corporate management to improve governance need to be introduced for legal and regulatory measures to have full effect.

67. **Important measures are being undertaken to improving corporate governance.** The corporate ownership structure is becoming more balanced with less bank control and cross ownership and a bigger share of individual and foreign ownership. Shareholder rights are assuming greater importance and growing institutional shareholder activism is a positive development. Boards of directors still include relatively few outside directors, but the revision to the Commercial Code which took effect in April 2003 that gives corporations the option of a specific governance structure with a majority of outside directors could potentially be an important step forward. Standards for accounting have been brought toward international best practices and the accounting and auditing infrastructure is being enhanced to bring it up to the task of implementing the new standards. Further measures should involve development of takeover markets and steps to promote greater shareholder activism.

Legal framework for corporate insolvency

68. **The Japanese authorities' initiative in reform of the insolvency laws is commendable but there is some room for further improvement.** The system now generally works quite well. However, despite the recent legal reforms the framework remains complex and invites noncooperative behavior by debtors and creditors. Thus, further developments are warranted in order to expand the tools for alleviating the current over-indebtedness in the corporate sector and more generally to serve the prospective needs of the economy.

69. **The insolvency laws should be amended to foster a more active role for creditors in the resolution of corporate debt problems.** Creditors now typically defer to the debtor company's management and the "main bank" during the deterioration of the company's financial condition and then rely on the court-appointed administrator after insolvency proceedings are initiated. In order to enhance the collective involvement of creditors during insolvency proceedings, the law should provide that the costs incurred by creditors' committees shall be borne by the debtor as an administrative expense of the proceeding.

VI. Supervision and Other Elements of the Financial System

A. Supervision

70. **The FSA has made immense strides since it was established only a few years ago.** Its resources have been substantially expanded. New skills have been recruited and the institution's ability to assess risk management has increased significantly. Nonetheless, more can be done. Staff recommends that the following issues be given early attention.

71. **The FSA's autonomy should be enhanced.** Unlike most supervisory agencies the FSA has no board with outside members to whom the Commissioner as chief executive could be accountable. Such a structure would help remove the FSA further from the political arena. It would be advantageous if it were made clear in the legal framework that neither the Prime Minister nor the Minister for Financial Services has a role in the taking of decisions on individual supervised institutions, except where the use of public money is involved.

72. **Modification of the current frequent rotation system for FSA staff would enhance expertise.** Specialization, including the recruitment of those with private sector experience, should be further encouraged for supervisors and examiners.

73. **The FSA should increase supervisory/inspection staff including actuaries and reinsurance specialists.** The FSA has reported that its first three actuaries have joined the staff since the FSAP mission and a reinsurance expert has also been hired. The BCP assessment concludes that the FSA carries out its off-site and on-site supervisory process thoroughly and the deficiencies relate more to the authorities' inability to prevent the erosion of the capital base of the banks.

74. **Greater attention should be paid to governance issues.** Corporate governance requirements that now appear in guidelines and the inspection manual are not statutory instruments. Although the current system functions well, it would be preferable if they were given the force of law. Banks and insurance companies should be required to establish audit functions with at least half of the members drawn from independent persons. The government's actions in this regard with respect to Resona should be used as a model.

75. **The FSA should not be responsible for implementing government policies that fall outside its supervisory responsibilities.** Its responsibilities should be limited to the prudential supervision of financial institutions. Responsibility for auditing standards could be

devolved to a body outside the FSA with private sector participation in a similar fashion to that adopted for the setting of accounting standards.

76. **The FSA should make greater use of external auditors of financial institutions.** Although contacts with auditors have increased in recent years, there is scope for further use of their resources. For example, auditors should be authorized to communicate findings to supervisors and be asked to report on internal controls and similar issues on which they have expertise. In the insurance sector, moreover, the FSA should be provided with legal authority to delegate on-site inspection functions totally or partly to third parties such as independent actuaries, auditors, etc.

77. **The arrangements for the exchange of information with the BoJ and other regulatory bodies could be formalized.** Although no problems have arisen, the formalization of these arrangements could avoid duplication and increase the use of the specialist skills of the BoJ and other authorities.

78. **The government has taken steps to liberalize the insurance sector over recent years, the effects of which will require careful monitoring by the insurance supervisor**. The marketing of insurance products now requires only notification to the FSA, rather than approval. Insurers are now free to set premium rates at whatever levels they wish, and distribution channels have been liberalized so that life and non-life insurers can compete in each others' markets, and banks can also sell some insurance products. Policy form approvals have become more streamlined and the FSA has adopted a procedure that, while companies will continue to file new policy form proposals with the agency, it will not insist that they be approved before policies are sold.

79. **In the insurance sector limits need to be imposed on certain investments.** Use of derivatives should be limited to hedging purposes. There should also be limits on a single exposure (e.g., a specific real estate project) as well as on aggregate counter-party exposures.

B. Safety Nets

80. **Safety net arrangements are well-developed and broadly appropriate.** In particular, postponement of full implementation of the limited deposit insurance scheme from April 2003 reflects the continuing fragility of the banking system. The implementation of the reforms recommended in this report should contribute to a more stable system and eventually to a return to partial deposit insurance coverage.

81. **Staff agrees with the decision to defer proceeding with the withdrawal of the remaining component of the deposit insurance blanket guarantee in April 2003.** The authorities have bought time with this decision, which does seem to envisage a permanent unlimited guarantee of a subset of demand deposits. It is expected that insurance premia will be higher on deposits with unlimited coverage which presumably means that banks will pass on the cost to the users, that is to those depositors who wish to pay for them. Full coverage will thus essentially become voluntary, an unusual concept. It seems likely that the willingness of depositors to volunteer will depend on their assessment of the likelihood of

uninsured depositors incurring loss, an event that has not yet occurred. Staff believes that the credibility of the deposit insurance scheme would be enhanced if the DIC's deficit (¥3.4 trillion as at the end of FY 2002) were to be written off by the government.

82. **The BoJ's last resort facilities appear to work well and cooperation on crisis management issues between the BoJ and the FSA seems satisfactory.** The Resona case appears to have been handled effectively. Further modification may be necessary to take account of the new deposit insurance regime initiated in April 2002 whereby depositors can incur losses. As a result, confidence factors are likely to be more pronounced and demands for emergency liquidity might well arise more frequently and quickly.

83. **The bank resolution framework has been refined several times in the light of the extensive experience accumulated in recent years.** In the new circumstances more formal arrangements for enhanced exchange of information at the pre-crisis stage between the FSA and the BoJ on the one hand, and the DIC on the other, might well be needed. Staff was informed that informal arrangements work well, and this may be so in crisis situations, but more structured arrangements would help to ensure that all those involved are in possession of information that would give an early warning of difficulties.

C. Payment System and Securities Settlement Issues

84. **Overall, systemic risks arising from the payment system appear limited but measures could be taken to improve risk control.** A number of reforms have strengthened the efficiency and safety of the payment, clearing, and settlement arrangements including the implementation of the real-time gross settlement mode in the BoJ-NET Funds Transfer System, the core interbank system. The BoJ has established the Payment System Forum to bring together the operators of private-sector payment systems, and key participants in them, to discuss issues of common interest and has enhanced communication to the public of systemically important payment systems and the BoJ's various roles in the payment system in Japan.

85. **Uniformity of the legal framework for securities settlement systems will be enhanced by the new Law concerning Book-Entry Transfer of Corporate and Other Debt Securities, which went into effect in January 2003.** However, a uniform legal framework should also be applied to stocks. If the shift to dematerialization is slow, some actions may be necessary to avoid risks and costs (including back-up costs for the users) associated with coexistence of different kinds of custodian practices and with paper-based settlements. An extensive use of the planned DVP facilities may need to be encouraged to cover possibly all kind of assets and transactions. The Japan Securities Clearing Corporation, established under the Securities and Exchange Law, took over as central counterparty from the stock exchanges in January 2003.

86. **There is room for a more active ongoing oversight of the securities settlement systems.** The authorities in charge of oversight do not monitor on an ongoing basis the systems and settlement procedures followed by major players for those markets that are not served by a central depository. A more effective daily monitoring of the smooth functioning

of private securities settlement systems as well as market practices of some important players involved in custody and liquidity provision would be useful.

D. Public Debt Management

87. **Overall, public debt management practices in Japan are consistent with the existing international practices.** Japan's central government debt management practices were reviewed using the IMF-World Bank Guidelines for Public Debt Management as a framework. In light of the size of the Japanese public debt, appropriate debt management practices are important to safeguard financial stability. The coordination of debt management is well established. The authority to borrow rests on a clear legal base. The institutional framework for debt management provides a clear definition of roles and responsibilities. The MoF manages debt in a transparent and predictable manner.

88. **The risk management framework could be further expanded.** The MoF does not employ quantitative models for calculating the risk in the debt portfolio, nor does it analyze the trade-off between risks and expected costs. Thus, the understanding of risks and costs associated with the debt portfolio could be improved. Specialized risk analysis based on modern portfolio theory could help to structure discussions on alternative debt strategies leading to policy decisions and will make it possible for debt managers to provide the fiscal authorities with information on the costs and risks associated with the government financing requirements and debt level. Adequate resources must be allocated for this task, including the necessary technical infrastructure. Staff also recommends that the government closely monitor the risk exposure implicit in government guarantees.

E. Transparency Issues

89. **Observance by the BoJ of the IMF Code of Good Practices on Transparency in Monetary and Financial Policies in the conduct of monetary policies meets a very high standard.** BoJ officials at the Policy Board level are supportive of the transparency concept and view transparency as an evolutionary and ongoing process. The BoJ is prepared to broaden and strengthen the practice of transparency at the BoJ further and is receptive to new initiatives in this regard. The BoJ utilizes a variety of means to disclose and explain information (both in Japanese and English) about its policies and activities, including a number of scheduled reports mandated by the BoJ Law (such as the outlines of discussion of Monetary Policy Meetings and transcripts of such meetings at a later date, and semi-annual reports to the Diet), the Annual Review (in English), and the annual Outline of Business Operations (in Japanese). In addition, it fosters transparency through press releases, press conferences, public consultations, speeches by its officials, and a well-designed and user-friendly website.

90. **The assessment concludes that the respective Japanese authorities broadly observe the financial policy section of the Transparency Code.** Statutes are modern and state clearly objectives and responsibilities. Staff also conducted an assessment of Japan's observance of the IMF's Transparency Code with regard to financial policies. This involved the supervisory activities of the FSA in respect of banks, insurance companies and securities

firms, as well as the activities of the SESC, and the oversight of payment systems by the BoJ. Staff also reviewed the activities of the BoJ in respect of the supervision of those financial institutions with which it conducts market operations, as well as the activities of the DIC. Both the FSA and the BoJ produce a host of material including substantive annual reports and other regular documentation, even though not always legally obliged to do so. They also both go to considerable lengths to describe their activities through frequent press conferences and speeches. Senior officials account frequently to the Diet on their activities. The DIC has gone to great lengths to explain the deposit insurance scheme and the extent to which depositors are protected by it.

F. AML/CFT Framework

91. **A partial review was conducted of the legal and institutional framework for AML/CFT, including a review of preventive measures for the banking, insurance and securities sectors.** A full assessment of Japan's AML/CFT regime, culminating in a ROSC, will be undertaken in the fall of 2003.

92. **In recent years, there have been substantial positive developments in Japan's AML/CFT framework.** Japan had criminalized money laundering related to drug offences through the Narcotics Special Law as early as 1992. The Law for the Punishment of Organized Crimes, Control of Crime Proceeds and Other Matters (POCL) enacted in February 2000, broadened the scope of predicate offences beyond drug-related offences. The financing of terrorism became a criminal offence through the Act on Punishment of the Financing of Offences of Public Intimidation in 2002 and terrorist financing was added to the list of predicate offences. The Law on Customer Identification and Record Retention of January 2003 established customer identification and record keeping requirements for financial institutions. Banks, foreign exchange dealers, insurance and securities companies report directly to the Japan Financial Intelligence Office (JAFIO); other institutions report suspicious transactions to their primary regulators that forward the reports promptly to JAFIO. This indirect process impedes the timely reporting; further streamlining of reporting procedures would minimize the reporting delays.

93. **JAFIO analyzes suspicious transaction reports and disseminates the information to law enforcement.** JAFIO has routine access to information from the FSA; however, its access to administrative and law enforcement information is limited. Consideration should be given to granting JAFIO greater access to administrative and law enforcement information to support its analytical capabilities. The staffing level for the JAFIO does not appear sufficient.

OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES: SUMMARY ASSESSMENTS

This appendix contains summary assessments of adherence to the major international standards and codes applicable to the financial sector. The assessments have helped to identify the extent to which the regulatory and supervisory frameworks are adequate to address the risks in the financial system. They have also provided a source of recommendations for improved financial regulation and supervision in various areas.

Detailed assessments of standards were undertaken based on a collegial peer review process as part of the FSAP by: William Ryback (Federal Reserve Board), Stefan Spamer (Bundesbank), and Tarisa Watanagase (Bank of Thailand) for the *Basel Core Principles for Effective Banking Supervision;* Alan Cameron (formerly Australian Securities and Investment Commission) for the *IOSCO Objectives and Principles of Securities Regulation*; Donald McIsaac (World Bank) and Helmut Müller (formerly German Insurance Supervisory Agency) for the *IAIS Insurance Core Principles;* Sean O'Connor (Bank of Canada) for the *Core Principles for Systemically Important Payment Systems*; and Charles Siegman (formerly Federal Reserve Board), Peter Hayward (IMF), and the sectoral experts for the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies*.

The authorities were requested to complete self-assessment questionnaires for each standard or code in advance of the mission. The questionnaires and self-assessments were made available to the peer group of experts in advance of the mission. During the mission, the responses to the questionnaires and self-assessments of compliance with the standards and principles were clarified and checked through subsequent discussions with the authorities and market participants in critical areas.

The assessments conclude that substantial improvements have been made in the supervisory process since the FSA was set up. However, it is not clear that the authorities are yet in a position to enforce their requirements fully, especially with regard to the valuation of assets and the quality of capital. The institutional structure also creates scope for the FSA to be subject to political pressures and the FSA would benefit from more and better qualified staff.

The assessments have been discussed in detail with the Japanese authorities but responsibility for the assessments remains that of the assessors. The authorities' response to the assessments is included at the end of each summary.

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. General

1. This assessment of observance of the Basel Core Principles for Effective Banking Supervision was conducted on the basis of the *Core Principles Methodology* of October 1999.[1] The assessment examined the degree of observance of each of the essential criteria and the additional criteria where the assessors judged that necessary. The Financial Services Agency (FSA) and the Bank of Japan (BoJ) cooperated fully with the assessment and provided extensive clarification in the form of documents and oral explanation. Their assistance is gratefully acknowledged. The assessors also had discussions with commercial bankers, bankers' association representatives, accountants, and other market participants.

B. Institutional and Macroprudential Setting: Market Structure Overview

2. The Japanese financial system was designed, to some extent, on the continental European model, that is, it was bank centered, and has largely remained that way. Segmentation among different types of financial institutions coexists with structural cross-shareholdings among these institutions. Trust banks, either independent or as subsidiaries of major banking groups, are designed to provide asset management services as well as conventional bank functions. Other commercial banks, including some foreign banks, have started de novo trust bank subsidiaries.

3. Following the bursting of the real estate and equity bubbles in the early 1990s, the capital position of the banks began to decline, and the gearing effect of their equity holdings went into reverse. Their exposure to real estate, especially commercial real estate in the major metropolitan areas, led to a rapid rise in nonperforming assets. All the major banks suffered severe losses. Because of inadequate accounting and supervisory processes, these losses were disguised for some time and confidence in the system eroded. The authorities responded with an explicit guarantee of bank liabilities, in practice extended to subordinated debt liabilities as well.

4. Following a series of mergers in the 1990s; the major banks are now down to five groups and two independent trust banks. There is a large group of regional banks whose viability is strongly influenced by the state of the local economy. Takeovers by city banks of regional banks have been rare. Most regional banks benefit from the lower minimum capital requirement of 4 percent applied to "domestic" banks, as opposed to the 8 percent capital requirement for "internationally active" banks. Foreign banks in Japan have a relatively small market share of about 3 percent of total assets. A very large number of local shinkin banks and credit cooperatives serve individuals and small businesses in local areas. In addition, there are a large number of agricultural cooperatives, which are members of a jointly owned

[1] The assessment was conducted by William Ryback, Federal Reserve Board; Stefan Spamer, Deutsche Bundesbank; and Tarisa Watanagase, Bank of Thailand, in October 2002.

central institution, Norinchukin Bank, which manages their liquidity and is a very large player in the JGB market.

5. All of the banks and deposit-taking institutions described above are licensed under the Banking Law or other relevant laws and supervised by the Financial Services Agency with the exception of the agricultural credit cooperatives and the Norinchukin Bank. These and some smaller fisheries cooperatives and labor banks are supervised jointly by the FSA and respective government departments. In addition, a number of specialized Government Financial Institutions (GFIs) are not licensed under the Banking Law and hence are not supervised by the FSA. However, the FSA is scheduled to inspect risk management in the GFIs. In such cases, it will be up to the sponsoring minister to take any action needed in light of the inspector's report.

6. Japanese banks' operating profits have been low for the past decade. Estimates of capital adequacy disclosed by internationally active banks (mostly city banks and a few regional banks) remain above 8 percent, while the capital adequacy ratios disclosed by domestic-oriented banks are, for the most part, above 8 percent and all are above the 4 percent minimum.

C. General Preconditions for Effective Banking Supervision

7. The FSA was created in July 2000 by integrating the functions of the Financial Supervisory Agency and the Financial Planning Bureau of the Ministry of Finance. In January 2001, with the abolition of the Financial Reconstruction Commission in conjunction with the reorganization of the central government ministries, the Financial Services Agency was established as an external agency of the Cabinet Office. The FSA Law (FSAL) and its implementing ordinance provide for the establishment of other supervisory and deliberative bodies including the Securities and Exchange Surveillance Commission (SESC), the Financial System Council, the Compulsory Automotive Liability Insurance Council, the Certified Public Accountant Examination and Investigation Board, and the Business Accounting Council. At the end of fiscal 2002, the FSA employed a total of 981 staff. Under the provisions of Art. 11 of the Law Establishing Cabinet Ministries, a Special Minister for Financial Services (MFS) was established and charged with the mission of providing overall leadership regarding matters under the jurisdiction of the FSA.

D. Summary of the Basel Core Principles for Effective Supervision Assessment

8. **Preconditions for effective banking supervision (CP 1):** The basic legal framework is contained in the FSAL, the Banking Law, Cabinet Ordinances, Cabinet Office/Ministerial Ordinances, and Administrative Guidelines issued pursuant to the Banking Law. These provide powers for the FSA to supervise banks. The FSA is not responsible for the supervision of the GFIs.

9. Although the removal of responsibility for supervision from the Ministry of Finance and the setting up of the FSA was a major step forward, there appears to be a lack of operational independence. The constitutional framework of the FSA—with a minister who

effectively has control over the operations of the supervisor—creates scope for the FSA to be subject to political pressures. The FSA is responsible for ensuring that banks comply with the conditions imposed on the recipients of public capital injections in 1998/99, including a requirement in 1999 that they increase their lending to SMEs to ease a potential credit crunch. The FSA has no budgetary independence, and is funded from the central government budget. The FSA operates with minimal supervisory staff levels. Additional staff may be needed to solve the continuing asset quality problem and following implementation of the pending revised Basel Capital Accord.

10. There are in general no formal procedures for a regular exchange of information in place between the BoJ, which also examines banks and other major financial institutions, and the FSA, although such exchanges take place on an ad hoc basis and the organizations maintain close contact at operational and senior official levels. Nevertheless, a request for information could be rejected on legal and confidentiality grounds. The exchange of information with foreign banking supervision authorities, including on-site visits, is generally based on informal arrangements.

11. **Licensing and Structure (CPs 2–5):** The Banking Law clearly defines the term "bank" and the permissible activities of banks, but does not deal with the so-called GFIs and the Japan Post, which carry on lending and deposit-taking business respectively and compete with commercial banks.

12. Prior to engaging in banking businesses, each institution is required to obtain a license from the Prime Minister, who normally delegates his functions to the Commissioner of the FSA, and is the sole authority for granting banking licenses. Under the Banking Law the FSA has authority to grant authorization for acquisitions or an increase in qualifying holdings. The Banking Law has a clear definition of "significant" ownership ("major shareholding") which requires approval and provides for immediate notification in the case of an increase in a qualifying holding to more than 20 percent. The FSA has powers to obtain information from and inspect a "major shareholder" and can revoke the approval if conditions cease to be met.

13. Laws or regulations define the types of permissible investments only in very general terms. The upper limit imposed by the provisions of the Banking Law is 5 percent of the total number of outstanding shares of a domestic corporation with voting rights. Supervisory approval is not required for investments within the limit. Investments in other companies that are neither banks, financial institutions nor ancillary banking undertakings are not restricted in terms of the proportion of the bank's own capital, although such investments are subject to the large exposure limits.

14. **Prudential Regulation and Supervision (CPs 6–15):** The prudential authority, the FSA, carries out its responsibility for prudential oversight by conducting on-site inspections as well as off-site analysis. The inspection manual is thorough and covers all major risks to an institution. Staff is adequately trained and, in most observed cases, experienced. The FSA has recently implemented a policy of more continuous supervision of major banks and this is

an important step forward. The FSA is also dedicating staff to certain specific risk categories such as market risk, internal controls, and information technology to improve supervision in these important areas. The FSA has the power to require banks to take corrective or remedial actions. A prompt corrective action scheme is in place and observed by the supervisory authorities.

15. The banking law provides authority for the supervisor to set capital adequacy standards. Capital adequacy is assessed during on-site inspections. The composition of capital for major banks, while built upon the Basel framework, is over reliant on two components—deferred tax assets and preference shares, much of which have been subscribed by the government. Major banking groups are weakly capitalized. Capital levels for banks that are not internationally active are set at a lower level but there does not appear to be a justification based on relative risk profiles.

16. Current provisioning requirements are based on accounting standards and guidelines issued by the JICPA. Banks are required to conduct frequent assessments of their portfolio and make sure that provisioning requirements are in line with FSA guidance. The on-site inspection process checks observance. The focus of problem identification and resolution is the category called nonperforming loans (NPLs) which includes loans requiring special attention, in danger of bankruptcy, de facto bankruptcy, and bankrupt. Loans in the categories in danger of bankruptcy and below are essentially worthless and major banks are being encouraged to remove existing loans from their balance sheets by March 2004, and newly emerging ones within three years of classification.

17. Regulations provide adequate guidance regarding large loan exposure and this area is checked carefully during on-site inspections. Connected lending is also carefully monitored and requires, in many cases, a supermajority of the bank's board to approve such lending. Market, interest rate, operational, and other risks are adequately monitored during the on-site inspection. Prudential reports are required frequently. Country and transfer risk is not regularly reported, although inspectors check internal procedures; this presents an important risk where improvement is necessary.

18. Internal controls in individual banks are checked routinely during the on-site inspection process and the inspection manual is comprehensive. The recently conducted special review of certain large borrowers involved tri-partite discussions with auditors but discussion with auditors is not routinely incorporated into the supervisory process. Outside directors are not yet numerous in the boards of most banks. Oversight is conducted through statutory auditors that were traditionally part of the management of the bank in the past. The role of the statutory auditor is directed at ensuring that management carries out its responsibilities in an acceptable manner. The oversight of the routine audit function is a direct responsibility of the board and the audit function sometimes reports directly to the chief executive officer or chief operating officer. This may not in all cases provide the independence of the audit function that is desired.

19. On-site inspections are carried out to review banks' policies, practices, and procedures regarding anti-money laundering initiatives. The inspection manual is comprehensive. The FSA has the power to require correction of any deficiencies and this was noted in practice. The strengthening of customer identification procedures is in process as noted by planned implementation of a new law which took effect from the beginning of 2003.

20. **On-site and off-site supervision (CPs 16–19):** The FSA conducts on-site and off-site supervision. It reviews and monitors banks' financial conditions with the information and data required of banks. Sanctions apply when a bank fails to submit the required information in a timely manner. On-site inspection is used as a tool to verify that adequate and reliable systems and controls are in place. Inspection cycles vary depending on the risk, type and size of banks.

21. Focuses of supervision have shifted from regulator-led to a bank's self-assessment and from observance-based to risk-based. Supervisors have regular meetings with banks' management both in the course of monitoring and inspection. Inspectors make use of the work of both internal and external auditors but meetings with external auditors with the participation of bank management should be regular. The FSA does not have the authority to appoint or oppose the appointment of an external auditor.

22. **Consolidated supervision (CP 20):** The FSA supervises banks on a consolidated basis including the enforcement of prudential regulations such as capital adequacy and single lending limits. Supervision of non-bank financial institutions is integrated within the same agency. The FSA has the authority to request information or data from a bank subsidiary and to conduct on-site inspection of a subsidiary.

23. **Accounting standards (CP 21):** Accounting standards have seen significant improvement in recent years and are now generally in line with international standards. Auditing and disclosure standards have also been revised and improved.

24. **Remedial measures (CP 22):** The FSA is authorized to take an appropriate range of actions against a bank that requires remedial measures. The actions range from submission of business improvement plans to revocation of the license. Sanctions apply also to the board of directors, auditors and managers for violation of the Banking Law, including failure to observe corrective orders.

25. **Cross-border banking (CPs 23–25):** The current regulatory and supervisory framework does not have specific provisions relating to global consolidated supervision. However, banks organized under the Banking Law must notify the FSA for approval before they establish a subsidiary, branch, or agency. The FSA has the authority to supervise the overseas branches of locally incorporated banking institutions, e.g., through undertaking direct inspections.

26. There are no legal provisions for the sharing of information with other supervisors. Consideration should be given to formalizing the current informal information-sharing arrangements with foreign supervisors, especially so as to avoid restrictions with regard to

confidentiality. Such arrangements would facilitate on-site visits, in line with the ongoing trend towards internationalization which is also expected to increase following implementation of the new Basel Capital Accord. However, current informal arrangements have seldom impaired the FSA's ability to practice consolidated supervision, including on-site inspections if necessary.

27. Foreign banking institutions are subject to similar regulatory requirements applicable to all other banks operating in Japan. An exception is that a foreign bank licensed to operate in Japan needs approval from the FSA for opening each additional branch. The current legal provisions give the FSA powers to access any information in a subsidiary of a foreign banking institution. Nevertheless, there is no written or legal requirement for a formalized procedure in which the host country supervisor can share information on the local operations of foreign banks with home country supervisors, as confidentiality is protected.

Recommended Action Plan to Improve Observance of the Basel Core Principles

Reference Principle	Recommended Action
CP 1.2 Independence	Consider setting up a board for the FSA (as with the SESC) to help ensure visible autonomy and accountability. To guarantee budgetary independence, the supervised institutions should be charged by the FSA for the costs of supervision.
CP 1.6 Information sharing	Formalize arrangements for regular exchange of information with the `Bank of Japan. An obligation for external auditors to inform the supervisor of any material finding should be embodied in law.
CP 2. Permissible activities	Extend full supervisory authority of the FSA to GFIs.
CP 4. Control of banks	Need for FSA approval of an increase in a significant holding.
CP 5. Investments by banks	Need for FSA approval of amount of investments in relation to the bank's capital.
CP 6. Capital adequacy	Change definition of capital to limit inclusion of DTA. General provisions for Category II assets should not be in Tier-2. The capital adequacy ratio for domestic banks should be at least 8 percent.
CP 8. Loan evaluation and loan-loss provisioning	Loans should be valued on the basis of the net present value of expected recoveries.
CP 9. Large exposure limits	Limits should be reduced.
CP 11. Country risk	Country risk should be regularly reported and supervised.
CP 15. Money laundering	New customer identification law will need to be applied effectively.
CP 19. Validation of supervisory information	Need for the FSA to have the authority to appoint, or oppose the appointment of, an external auditor.
CP 21. Accounting standards	Need for the FSA to have the right to revoke the license of an external auditor.
CP 24. Host country supervision	Need for recognition in the law of the rights of supervisors to exchange information.

Reference Principle	Recommended Action
CP 25. Supervision over foreign banks' establishments	Introduce more formalized arrangements for the exchange of information with foreign supervisors.

E. Authorities' Response

28. The Japanese authorities consider the FSAP mission's findings and recommendations valuable and helpful, and, in many areas, work is already underway to attain improvement. For example, as to CP 15, the Law on Customer Identification and Record Retention has been in effect since January 2003, and, as to CP 8, major banks started to apply a discounted cash flow approach to evaluate loans of large borrowers categorized as "Need special attention" and "In danger of bankruptcy." Though the Japanese authorities are of the view that their capital adequacy regime is consistent with the Basel Accord, an advisory body to the FSA is currently studying the treatment of deferred tax assets and other relevant issues. The authorities also maintain that there are some recommendations that would merit further consideration whether their presumed benefits surpass those of the current regimes: for example, in the assessment of CP 2, the mission recommends extending full supervisory authority of the FSA to Government Financial Institutions, but the regime in which the ministry in charge of the policy objective of each institution assumes the full supervisory responsibility would have its own merits.

IOSCO Objectives and Principles of Securities Regulation

A. General

29. This section provides summary findings from the assessment of implementation of the IOSCO Objectives and Principles of Securities Regulation. The principal regulator of securities markets in Japan is the Financial Services Agency (FSA) and its associated agency, the Securities Exchange Surveillance Commission (SESC) which are the main subjects of this assessment. The main information source in making the assessment was a self-assessment prepared by the FSA, supplemented by: (a) documents furnished by the FSA, such as its Annual Report, and the Law to Establish the FSA (FSAL); (b) material obtained through the FSA's website, such as press releases and speeches by senior FSA officials, and from self regulatory organizations; (c) the Securities and Exchange Law (SEL), and a text book, *Securities Market in Japan 2002*, published September 2002; (d) interviews organized through the FSA with self regulatory organizations, market participants, industry groups, and others; and (e) lengthy discussions with senior staff of the FSA.[2]

[2] The principal assessor with respect to securities regulation was Alan Cameron, former chairman of the Australian Securities and Investments Commission, the Executive Committee of IOSCO, and the Joint Forum. The assessment with respect to clearing and

(continued)

B. Institutional and Macro Prudential Setting

30. The FSA was established in July 2000 as the successor to the Financial Supervisory Agency and the Financial Planning Bureau in the Ministry of Finance. The SESC had been created in July 1992 under the Ministry of Finance, but was transferred to the Financial Supervisory Agency when that was established in June 1998. Both are now governed by the FSAL.

31. Trading of securities in Japan is conducted on securities exchanges, alternative trading systems, and in the over-the-counter (OTC) market. Of the five stock exchanges in Japan, the largest is the Tokyo Stock Exchange (TSE) with a market capitalization of about ¥232 trillion in March 2003. In addition to the exchanges, stock trading is done in the JASDAQ market (an OTC market managed by the Japan Securities Dealers Association (JSDA)), over a proprietary trading system, and in off-exchange trading sites for listed stocks.

32. In the years since 1945, the dramatic growth and development of the Japanese economy to become the world's second largest has been facilitated, and was in large part measured, by the health of the Japanese equity markets. But that growth and development was financed in the main by bank based finance.

33. IOSCO sets out three objectives that should form a basis for an effective system of securities regulation: (a) the protection of investors; (b) ensuring that markets are fair, efficient and transparent; and (c) the reduction of systemic risk. The Japanese regulatory system is broadly designed to address each of these objectives and has traditionally appeared to favor a compliance approach to one which could be called risk based. However, the FSA's Inspection Manual does now provide for assessment of internal controls as part of its procedures.

C. Summary assessment

34. **Regulator (Principles 1–5):** These principles are all assessed as fully or broadly implemented. The mandate of the FSA is to assure the stable and efficient functioning of the Japanese financial system, as well as to protect depositors, policyholders, securities investors, and similar persons. The SESC is responsible for the administration of specified provisions of the SEL, the Law for Foreign Securities Firms and the Financial Futures Trading Law. The general effect of these arrangements is that the FSA is responsible for policy making, supervision and inspection, and the SESC for investigation and enforcement. Subsequent to the assessment the SESC acquired responsibility for administering some aspects of the Law on Customer Identification that came into force in January 2003.

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settlement systems was conducted by Ms. Daniela Russo of the European Central Bank. The assessments were carried out in October 2002.

35. The FSA is "an administrative agency within the Cabinet Office". The SESC is established within the FSA by the FSAL. The head of the FSA is the Commissioner, appointed by and capable of removal by the Prime Minister. The Minister for Financial Services provides guidance to the Commissioner and coordinates the work of the FSA with the rest of government, but does not direct the FSA, whose Commissioner reports to the Prime Minister, who can give directions to the FSA on policy matters. The Minister is nevertheless frequently described as the "head" of the FSA. This organizational structure does not give the FSA in particular the appearance of independence which would best assure its ability to perform and be seen to perform all of its responsibilities with independence.

36. The SESC is to "exercise independent authority" (article 9 of the FSAL), and its commissioners are appointed by the Prime Minister subject to approval by both houses of the national legislature. The commissioners are to be apolitical during their terms of office, and can only be removed by the Prime Minister if their fellow members decide that they have become incapable of acting or have acted in contravention of their authority.

37. The staff of both agencies are civil servants, and are subject to the duties and responsibilities, to removal for cause, and to transfer and rotation among agencies under the relevant general rules for all civil servants in Japan. The leadership and staff of the FSA and the SESC are protected by the National Civil Service Law, in the same way as other civil servants for acts done bona fide in the course of their duties. Specific protection for the leadership or staff of those bodies beyond that provided by the National Civil Service Law would be desirable.

38. The FSA and the SESC are funded as part of the government budget. Their operational independence should be established by more secure funding so that it does not depend on the outcome of the annual government budget. Despite the general reduction in public sector employment imposed by the government, the FSA and the SESC have been permitted to recruit significantly in FY 2002, and are budgeted to increase in total to about 1,000 staff. But the market place reports perceptions that staff is over worked, and responses to issues are thought by some to take too long. Further, the rotation of the staff from time to time among agencies unrelated to financial supervision and regulation means that it is difficult to build up industry knowledge and expertise. This aggravates the staff shortages referred to above.

39. **Self-Regulatory Organizations (Principles 6 and 7):** Japan makes extensive and effective use of self regulation, and the principles are both fully implemented. The general perception appears to be that the SROs are neither too lenient nor too harsh, and provide front line regulation which is closer to the market. However, there are also concerns. First there may be too many regulators whose activities and (to some extent) mandates, overlap, with FSA and the SESC conducting their own inspections, as well as the stock exchanges, the JSDA, and the Bank of Japan; and several of these may also penalize the one firm for the same misbehavior. Efforts are made to coordinate inspections, but firms report overlap. Second, some SROs do need to reconcile sometimes conflicting roles as SROs, industry bodies and market operators.

40. **Enforcement (Principles 8–10):** The FSA and the SESC between them have comprehensive inspection, investigation, surveillance and enforcement powers.

41. A Financial System Council Report, *Overview of the Medium-term Vision for the Future of the Japanese Financial System*, September 2002, noted that it was necessary to boost confidence in the players in the market, including issuing companies, market intermediaries, and market operators, so that the market mechanism gains sufficient public confidence. To achieve this, the outcomes of the enforcement activities of the FSA and the SESC may need both to increase in number and to become more focused on substantial wrongdoing.

42. **Cooperation (Principles 11–13):** The FSA believes that it has authority to share both public and non-public information with domestic counterparts pursuant to the FSAL and the National Civil Service Law, when they believe that the public interest in sharing information outweighs the public interest in maintaining confidence; and with a foreign authority, if it considers it reasonable to respond to a request. The Law does not permit cooperation if the foreign regulator would not respond to a similar request from Japan, where action might "exert a serious influence to the detriment of the capital market of Japan or undermine other interests of Japan," or where any report might be used for other purposes. The authority to share information on an unsolicited basis is somewhat tenuous.

43. While the Principles are regarded as fully implemented, the authority to share information domestically could be expressed more clearly, and the ability to decline to cooperate with foreign regulators' requests ought to be limited to specific grounds, with the presumption being in favor of cooperation. In general, the laws in this area should be reviewed fundamentally, so that the exchange of information of a supervisory and an enforcement kind is positively encouraged both domestically and internationally, and all relevant agencies encouraged to enter into agreements laying down clear expectations as to when and how that will happen; laws of general application in the civil service are unlikely to work to achieve optimal financial regulation.

44. The FSA has a small number of formal MOUs . The process of negotiating and agreeing when, what and how information will be exchanged among government agencies, and with SROs, provides an opportunity to increase the effectiveness of the regulatory regime, and minimizes any risk of serious gaps in regulation. The efforts of the SESC and the FSA to formalize more such arrangements should continue. The provisions intended to enable the FSA and the SESC to cooperate with their foreign counterparts should be reviewed and strengthened, but are in some respects better developed than the domestic equivalents.

45. **Issuers (Principles 14–16):** These Principles requiring full, accurate and timely disclosure of financial results and other information that is material to investors' decisions, are also regarded as fully implemented. In line with developments in other major markets, Japan intends to enhance its continuous disclosure mechanism, by taking measures to require disclosure of risk information, management discussion and analysis, and governance

information, by March 2003; and to develop guidelines within the exchanges and the JSDA on quarterly disclosure of financial and business performance.

46. There are provisions in the Commercial Code which are designed to ensure that holders of securities in a company should be treated in a fair and equitable manner.

47. The Principle requiring accounting and auditing standards to be of a high and internationally acceptable quality, is broadly implemented. It is accepted that important changes have been made in the accounting and auditing standards during the past five years that have brought them closer to international practices. The business combination (mergers and acquisition) standard remains to be changed. There is now an increasing need to focus on implementation of accounting and auditing standards. While the number of CPAs is significantly small compared with that of U.S. and U.K., it is not so out of line with that of other G-7 countries.

48. **Collective Investment Schemes (Principles 17–20):** The Principle requiring that the regulatory system should set standards for the eligibility and the regulation of those who wish to market or operate a collective investment scheme, is broadly implemented. The introduction of a "fit and proper" test on persons who control such a company, will mean that this principle will then be fully implemented. Those Principles relating to rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets, disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme, and a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme, are fully implemented.

49. **Market Intermediaries (Principles 21–24):** Minimum entry standards for market intermediaries are laid down under the SEL. A securities company may not conduct its business unless it meets standards including with regard to its capital, a fit and proper test for directors, and becomes registered with the FSA. Similarly, the Law concerning the Regulation of Investment Advisers provides minimum entry standards. Neither it nor the SEL provides a fit and proper test for those who own or control such businesses. The law was amended in May 2003 to require a "fit and proper" test on principle shareholders of securities companies and investment advisers.

50. The SEL provides standards for internal organization and operational conduct of a securities company, prohibits securities companies from doing business without fulfilling the standards, and provides procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk. These principles are fully implemented.

51. **Secondary Market (Principles 25–30):** These Principles are assessed as fully implemented. For example, the FSA licenses markets on application, and examines such applications to determine whether the provisions of the articles of incorporation and business

regulations conform to laws and regulations and are adequate to ensure the fairness of, and facilitate, the trading conducted on the securities market of securities exchanges, and to protect investors. Ongoing regulatory supervision of exchanges and trading systems is required under the law. Transparency of trading is promoted by the SEL and by the Fair Business Practice Regulations of the JSDA. The SEL prohibits practices such as insider trading, market manipulation, and spreading of rumors, and prescribes criminal sanctions. An Ordinance prescribes such matters as deemed necessary and appropriate in the public interest or for investor protection for the purpose of restricting trading in securities by any securities company for its own account, or trading in securities of an excessive volume as the FSA deems detrimental to the orderly securities market of any exchange or the over-the-counter securities market.

D. Recommended Actions

- The FSA should be given more structural independence to better assure its ability to autonomously perform and be seen to perform all of its responsibilities.
- The agencies' operational independence should be established by more secure funding.
- The leadership and staff of the FSA and the SESC should be protected by statute when acting *bona fide* in the course of their duties.
- The FSA and SESC need to build up industry knowledge and expertise and also alleviate current shortages of specialized staff.
- The efforts of the SESC and the FSA to formalize MOUs with other supervisory agencies should continue.
- While important changes in the accounting and auditing standards during the past five years have brought them closer to international practices, the business combination (mergers and acquisition) standard remains to be changed. Further there is now a need to focus on implementation of standards rather than improving standards.
- The proposed introduction in 2003 of a "fit and proper" test on persons who control managers of collective investment vehicles was necessary to ensure that these vehicles are not controlled by inappropriate persons. This law has now been passed.
- The proposed introduction in 2003 of a "fit and proper" test on principal shareholders of securities companies and investment advisers was necessary to ensure that securities companies are not controlled by inappropriate persons. This law has now been passed.

E. Authorities' Response

52. The FSA considers that the FSAP assessment is valuable and clearly demonstrates Japan's very high degree of compliance with the IOSCO principles. In addition, the FSA and other relevant authorities have announced and carried out many reforms and programs in the areas of securities issues, securities markets, and corporate governance in recent years.

53. The staff points out the appearance of political interference in the FSA's work. However, in a democratic country, it is a matter of course that administration has a certain degree of relationship with politics. In this respect, Japan is not an exception. However, the authorities do not believe that the situation in Japan is so different from other developed countries. In Japan, the roles of the Commissioner of the FSA and the Minister for Financial Services are clearly stipulated in relevant laws respectively and are clearly divided in order to secure the autonomy of the FSA to the greatest extent possible, as the authorities for supervision and inspection of financial institutions are delegated to the Commissioner, not to the Minister, directly by the Prime Minister. Moreover, the Commissioner has the power of appointing staff. Further independence from the Cabinet means that the FSA should transcend democratic control based on the Constitution.

54. The leadership and staff of the FSA and the SESC are currently protected by statute when acting *bona fide* in the course of their duties. Based on the Article 78 and 82 of the National Public Services Law, national public servants including officials in the FSA, may not be dismissed against their will except in cases where they have been adjudicated bankrupt or for other legally defined reasons. Funding by the government's annual budget is much more secure than funding dependent on industry contributions or market transactions. Actually, the FY 2003 budget of the FSA is up 15.3 percent from the FY 2002 budget, an exceptionally high increase in the environment of overall administrative reform.

55. The FSA has been making efforts to develop broad and adequate experiences of its staff as integrated regulators and enhance their expertise by training on and off the job. In addition, the FSA and the SESC have been recruiting well experienced staff and greatly increasing the number of specialized staff such as former employees of securities firms, lawyers, and CPAs in recent years. The FSA has been making efforts to conclude bilateral MOUs with major foreign securities regulatory authorities.

56. The Business Accounting Council (BAC), an advisory body established within the FSA, is currently considering the comprehensive accounting standard for business combinations. In addition, from a viewpoint of focusing on implementation of standards, the Diet passed a bill on May 30, 2003 for comprehensive revision of the Certified Public Accountants Law. The revised law includes measures to enhance auditor oversight and auditor independence, and to review CPA examinations for increasing the number of CPAs and enhancing the quality of CPAs. Revisions of the Securities and Exchange Law, the Law for Investment Trusts and Investment Companies and the Law for Investment Advisers passed the Diet on May 23, 2003. The revised laws include measures for introducing a "fit and proper" test of principal shareholders of securities companies, investment trust management companies and discretionary investment advisers.

IAIS Insurance Core Principles

A. General

57. The assessment was performed using the Core Principles Methodology adopted by the International Association of Insurance Supervisors (IAIS) at its meeting in October 2000. The main objectives of the assessment are to determine the levels of observance of the IAIS principles, and to suggest areas where further development may be appropriate.[3] The assessment was based on a review of the legal framework, and extensive discussions with the supervisory authorities and market participants. It focused mainly on the work of the various insurance units within the Financial Services Agency (FSA).

58. The FSA does not assemble and publish a statistical report of its own in respect of insurance business. However, there is extensive disclosure of financial information concerning insurance companies in Japan where companies are required to disclose even such proprietary information as the results of the solvency test and the component details that are developed in performing the test. As a consequence of this openness, insurance data is widely available. A reliable source of information is the journal "Insurance" published by the Insurance Institute of Japan. This collects company data direct from the source. Information is also published by the Life Insurance Association of Japan and the Marine and Fire Insurance Association of Japan.

B. Institutional and Macroprudential Setting—Overview

59. While Japan has the second largest insurance market in the world, there are a relatively small number of licensed companies. At the end of FY 2001, there were 43 life insurance companies, of which 25 were locally-owned, and 59 non-life insurers, of which 28 were locally-owned. The locally-owned companies are dominant in both markets.

60. In both the life and the nonlife sectors, the market share of the top ten companies exceeds 80 percent of the total market. For example, the 10 largest companies collected 85 percent of life insurance premiums in Japan in 2000. For life insurance, all but one of the top ten companies are mutual companies. For nonlife business, the 10 largest companies collected 80 percent of total premiums in 2000. Ninety-five percent of their revenues arise in Japan even though the largest companies do have international operations.

61. The insurance companies are an important part of the financial system in Japan. Reserves held by insurance companies in support of their obligations to policyholders amount to 38 percent of GDP, equivalent to approximately 25 percent of retail deposits with banks. There are no direct ownership linkages between insurance companies and banks.

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[3] The assessment was prepared by Mr. Donald McIsaac, lead insurance specialist, Financial Sector Department of the World Bank and Dr. Helmut Müller, former head of insurance supervision for Germany, in October 2002.

There are, however, significant cross-holdings between insurance companies and banks in terms of capital and capital-like instruments. Insurance companies hold shares, preferred shares and subordinated debt issued by banks. Banks hold so-called “foundation funds,” a form of capital for mutual companies, and subordinated debt issued by insurance companies.

62. Life insurance companies in Japan are under considerable stress as a result of the decline in interest rates and the decline in stock market prices. The older, larger, mutual companies have substantial portfolios of insurance products with a heavy savings element. Key to such products is the guaranteed rate of return on the policyholder’s “asset share” in the policy. For the last several years, investment income earned by the companies on their life insurance reserve funds has not been sufficient, taken by itself, to cover the rates of return that they have guaranteed to their policyholders. This “negative spread” represents the aggregate shortfall between investment income earned and the amount that is presumed to be credited to the policy liabilities during the current reporting period on the basis of the assumptions used to discount the liabilities. In FY2001 the total loss experienced by Japanese life insurance companies as a result of this interest rate deficiency amounted to ¥1.3 trillion. However, gains from low mortality and low costs surpassed the loss and resulted in ¥2.2 trillion of profits from basic insurance business operations. The companies’ actuaries project cash-flow for the next five years based on several conservative scenarios approved by the FSA. If it is unlikely that the loss arising from the negative spread will be covered by gains from other sources over the next five years, a deficiency provision for that period must be included in policy liabilities. One life insurance company established such a provision in FY2001.

63. The nonlife insurance sector in Japan continues to be profitable. The companies have not sought significant foreign business although several of the larger companies have licenses abroad. As their assets are concentrated in Japan, they could find themselves in a situation where they were faced with a simultaneous loss from both sides of the balance sheet, if a natural disaster were to be combined with a substantial fall in asset values—both developments arising from the same cause. Some companies are considering regional diversification to counteract this risk. In any case, nonlife business has been profitable and the companies have established substantial capital margins. Until recently, prices of insurance products were controlled and the emphasis was on adequacy of the premiums and not on competitiveness.

C. General Preconditions for Effective Insurance Supervision

64. Over the last decade, there has been a gradual deregulation of the insurance market in Japan. While the rating bureaus continue to review market conditions and to quote “reference” rates for insurance premiums, companies are free to depart from those rates if they choose. Policy form approvals have become more streamlined and the FSA has adopted a procedure so that companies can continue to file new policy form proposals with the agency, which will not insist that they be approved before policies are sold. While such developments help promote new product development and can in some cases help the consumer to obtain insurance at lower cost, the removal of controls raises a new set of

challenges for the FSA. Supervisors will have to develop new procedures and new skills—and be more vigilant—if they are to ensure they can identify financial problems in companies in time to take corrective action.

65. The FSA has moved toward a more risk-focused approach for the supervision of insurance companies by linking off-site supervision efforts with the work of on-site inspection. On-site work consists in reviewing with company management the risk management system and in attempting to assess the effectiveness of these systems and the remedial action that the risk management process may require. In order to make such a sophisticated approach to supervision function effectively, officials of the supervisory agency need to be highly experienced professionals who are themselves familiar with best practices in risk management. The FSA does not yet possess sufficient numbers of personnel with extensive industry experience and it lacks expertise in the actuarial and reinsurance areas, notwithstanding the fact that inspections are conducted by staff with long supervision experience. Since the assessment was completed, FSA has recruited several actuaries as well as an expert in reinsurance.

66. Unlike practice in some other financial markets, the auditor is not a partner with the supervisor in the protection of the savings of depositors and policyholders. However, the auditor has a special position in the business of monitoring financial institutions and that position has been accorded on the presumption that the auditor will also keep the interests of the policyholders in mind. In many other countries there is a closer relationship between the auditor and the insurance supervisor.

67. The Institute of Actuaries of Japan has issued standards of practice for its members and those standards enjoy the strong endorsement of the FSA. Actuaries are expected to comply with the standards, and in practice behave very much like the "appointed actuaries" in the United Kingdom; company actuaries make regular reports to the Board of Directors. Professional standards also impose upon the actuary a special reporting requirement. If the actuary identifies problems in the course of the investigation that appear to suggest a threat to the long term survival of the company, this must be reported to management for remedial action. If the actuary is not satisfied with the response of management, his findings must be reported to the FSA. Unfortunately, the FSA finds itself at present with the services of few qualified actuaries and it does not have the authority to obtain these services through outsourcing.

D. Main Findings

68. **Organization of Insurance Supervision.** The insurance staff at the FSA should be strengthened. The FSA requires experts with training and experience in areas such as actuarial science, reinsurance and risk management. At present there are very few qualified actuaries on its staff. Since so much of the supervisory work depends on inspections, the resources of the inspection staff should be increased in order to permit more frequent inspections.

69. **Corporate Governance and Internal Controls.** The FSA has issued guidelines to outline its expectations as to corporate governance and internal control practices in insurance companies. These guidelines reflect commendable practices. The guidelines are not statutory instruments, but considered to be the interpretation of the laws. This method functions well at present, but it would be preferable if these rules were enshrined in the statute or in formal regulation.

70. **Prudential Rules.** The FSA is reluctant to establish investment limits, believing that these would place excessive impediments on a company's ability to manage its investment portfolio effectively and efficiently. In the supervisory process, the FSA focuses on risk management and disclosure. However, limits on transactions with related parties and a limit on the maximum exposure to any single risk could be imposed without depriving company management of considerable latitude to establish its own rules. At present companies have been pursuing aggressive practices in trading in derivatives. Their objective in many cases is an attempt to improve aggregate investment returns rather than to hedge risks; it does not seem appropriate to place policyholders' savings at risk in this way.

71. **Prudential Rules.** The negative spread arising under guaranteed long term life insurance policies is a cause for concern. The companies should be obliged to establish deficiency reserves in any situation where it becomes apparent that the amount they expect to receive in future premiums and future investment income is not sufficient to support the promises they have made under their policies.

72. **Cross-Border Operations, Supervisory Coordination and Cooperation, and Confidentiality.** The FSA should cooperate further with insurance supervisors in other jurisdictions. Many jurisdictions have adopted the practice of executing Memoranda of Understanding to govern the exchange of information. FSA officials have expressed the view that it is sufficient to deal with problems on an ad hoc basis as the need arises.

Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
Organization of an Insurance Supervisor	
i.e., CP 1	Increase insurance supervisory/inspection staff, including particularly experienced actuaries and reinsurance specialists. Consider ways of making better use of third parties such as independent actuaries, auditors, etc.
Licensing and Changes in Control	
i.e., CPs 2–3	Complete the implementation of new rules concerning controls over ownership transfers.
Corporate Governance and Internal Controls	
i.e., CPs 4–5	The current guidelines are not statutory instruments, but considered to be the interpretation of the laws. This method functions well at present, but it would be preferable if these rules were enshrined in the statute or in formal regulation.

Reference Principle	Recommended Action
Prudential Rules	
i.e., CPs 6–10	Limits should be imposed on investments with related parties. It is also strongly recommended that an aggregate limit on exposure to derivatives as well as prudential limits on exposure to derivatives that do not constitute hedging be adopted until capacities for assessing an insurer's internal risk control are adequately developed. There should also be limits on a single exposure. Companies should be instructed to start systematic accumulation of the extra mathematical reserves necessary to compensate for the negative spread. It is also recommended that the procedure for the recognition of reinsurance in the calculation of technical provisions of primary insurers be improved.
Monitoring, Inspection, and Sanctions	
i.e., CPs 12–14	It is important to enhance further cooperation with auditors and actuaries in the supervisory process.
Cross-Border Operations, Supervisory Coordination and Cooperation, and Confidentiality	
i.e., CPs 15–17	Closer cooperation with foreign insurance supervisors is recommended, always respecting the need for confidentiality, through such means as the execution of MOUs.

E. Authorities' Response

73. The FSA has significantly increased its staff for off-site monitoring and on-site inspection in the insurance sector since its establishment and will continue to do so. In order to meet its needs for expertise, the FSA gives training to its staff through training courses and on the job training. In addition, it has employed staff with experience in the insurance industry or with actuarial qualification, and has plans to employ more with such backgrounds. The FSA will continue to strengthen its staff for off-site monitoring and on-site inspection.

74. The new rules in respect of requirements to be met when a change in control of insurance companies occurs became effective in April 2002 and are to be completely implemented in April 2004 when the transitional period expires.

75. The Insurance Business Law, Commercial Code, and Special law of Commercial Code stipulate the basic requirements for the corporate governance of insurance companies. The administrative guidelines stipulate the practical application of the law, and the inspection manual describes check-points for on-site inspection, both including corporate governance and internal control requirements. In case of infringement of these rules, it can request reports and issue orders as necessary. So far, the FSA does not have any problems with

enforcement. However, it will take appropriate measures such as the introduction of new regulations, when it becomes necessary in order to meet changing circumstances.

76. In order to avoid putting excessive impediments on investment activities and enable efficient investment, the FSA sets individual investment limits only when they are absolutely necessary and inspects/supervises insurance companies focusing on risk management and disclosure. The FSA routinely receives extensive reports from insurers on market risks, liquidity risks, and credit risks associated with their investment activities, and monitors them. In on-site inspections, the FSA checks insurers' exposures in detail and orders them to take corrective measures as necessary. In addition, insurers are required to publicly disclose the detailed information of their investment activities and risk management system; risks, risk management policy and organization for risk management. Therefore, introduction of individual limits which is pointed out, such as an aggregate limit on exposure to derivatives, their limited use to hedging purposes, limits on transactions with related parties and a limit on the maximum exposure to any single risk, is inappropriate.

77. In order to maintain adequate levels of policy reserve, actuaries project the cash-flow for the next five years based on several conservative scenarios approved by the FSA. If it is unlikely that the loss arising from the negative spread will be covered by gains from other sources over the next five years, a deficiency provision for that period must be included in policy liabilities. The FSA recognizes that the low interest rate has a serious impact on insurers and will continue to be vigilant, especially about the necessity of establishing deficiency provisions.

78. The FSA is considering the change of the recognition method of reinsurance from netting-out to gross. In addition, it is currently reviewing the methodology to assess the soundness of reinsurers who are the counter parties of insurers.

79. The FSA has cooperated closely with foreign insurance supervisory authorities and exchanged information through mutual visits by inspectors and other various communications. Information often exchanged relates to the financial strengths of individual insurers, administrative action on Japanese establishments of foreign insurers, vice versa, and fit and properness of managers. In recent cases, the FSA notifies foreign supervisors of proposed administrative actions against Japanese establishments of foreign insurers at an earlier stage than in previous cases. The FSA intends to further enhance the cooperation with foreign supervisors.

80. The FSA receives and relies primarily on reports by internal and external auditors and the actuaries' opinions on provisioning, dividend and future cash flow analysis. It has meetings with auditors and actuaries as well. In addition, the FSA frequently exchanges views with the Institute of Actuaries of Japan. The FSA will strengthen these relations.

CPSS Core Principles for Systemically Important Payment Systems

A. General

81. This section reviews the degree of compliance with the CPSS Core Principles (CPs) for Systemically Important Payment Systems (CPSIPS) of the four payment systems in Japan considered to be systemically important.[4] These systems are the BoJ-NET Funds Transfer System (BoJ-NET FTS), the Foreign Exchange Yen Clearing System (FXYCS), the Domestic Funds Transfer (Zengin) System and the Tokyo Clearing House's Bill and Check Clearing System (TCH-BCCS). The BoJ-NET Funds Transfer System and the Foreign Exchange Yen Clearing System each have two "modes", or sub-systems, that are assessed individually. There is a real-time gross settlement mode and a deferred gross settlement mode (i.e., simultaneous processing at designated times) in the BoJ-NET FTS while the FXYCS has both real-time gross settlement and deferred net settlement modes. The detailed answers to the IMF questionnaires by the Bank of Japan, private system operators, and other public and private agencies, a published self-assessment of the private systems by the Japanese Bankers Association, and a number of other relevant documents were used to inform the assessment. Additional information was obtained through extensive discussions with the Bank of Japan, the Tokyo Bankers Association, which is responsible for the systemically important private systems, and some key participants and service providers.

B. Institutional and Market Environment

82. The BoJ-NET FTS, which is operated by the Bank of Japan, is the core system, accounting for around 65 percent of the aggregate value settled by the four systemically important systems. The other three private systems settle their net obligations over the BoJ-NET FTS. The cash leg of a range of securities transactions involving, most notably, JGB and non-JGB debt instruments, as well as derivative transactions in the Tokyo International Financial Futures Exchange, also settle over the BoJ-NET FTS. The majority of these payments are processed and settled through the BoJ-NET FTS' real-time gross settlement mode. Only a few specific types of payments, such as those involving the settlement of non-JGB transactions or the Bank of Japan as a counter party, use the deferred gross settlement mode.

83. The FXYCS, which is owned by the Tokyo Bankers Association but operated under agreement by the Bank of Japan, clears and settles the yen leg of foreign exchange transactions. Most of the volume and value of payment obligations are cleared and settled through the system's deferred net settlement mode. The real-time gross settlement (RTGS) mode in the FXYCS is typically used only when the deferred net settlement mode is unavailable to participants and for the settlement of yen payments involving CLS Bank. In

[4] The assessment was prepared by Mr. Sean O'Connor (Bank of Canada) in October 2002.

the RTGS mode of the FXYCS, the individual payment obligations are passed straight through to the BoJ-NET FTS for settlement.

84. Essentially a retail payment system, the Zengin System clears and settles about 94 percent of the aggregate payment volume through the four systems but only about 9 percent of the value. It is a deferred net settlement system, owned and operated by the Tokyo Bankers Association. Even though the majority of the payment items handled by the Zengin System are small-value credit transfers, the system also handles some individual large-value payments.

85. Unlike the other three principal systems that are credit-transfer systems, the TCH-BCCS is a debit-pull system that clears and settles due bills of exchange and checks. In Japan, both instruments are used almost exclusively for business-to-business payments. Of the 540 clearing houses in Japan, the Tokyo Clearing House is the largest. It is an automated clearinghouse operated by the Tokyo Bankers Association. Although it handles only intra-regional payment items, it still clears and settles about three-quarters of the total value of bills and checks used in Japan. However, this value currently accounts for only about 5 percent of the aggregate volume of payments cleared and settled by the four principal systems and this share has been declining in recent years. The inter-regional collection of bill and check payments is settled over the Zengin System.

86. The Bank of Japan is solely responsible for the oversight of payment systems in Japan. Although it has no discretionary regulatory powers over private systems, the BoJ uses the contractual agreements with the participants in these systems, and the central counterparty (i.e., the Tokyo Bankers Association) in the FXYCS and the Zengin System, regarding access to its settlement and credit facilities to support the “moral suasion” used as its principal oversight tool. As the payment system oversight body, the BoJ participates in a network of advisory councils and working groups organized by various Ministries that have influence over some aspects of payment services in Japan.

C. Main Findings

87. Both modes of the BoJ-NET FTS and the RTGS mode of the FXYCS accord closely with the CPSIPS. Although the deferred gross settlement mode of the BoJ-NET FTS does not observe fully the Core Principles regarding the effective management of settlement risks and the certainty of prompt and final settlement, the deviations have no significant systemic implications for BoJ-NET FTS and other payment or financial systems. With regard to the deferred net settlement mode of the FXYCS and the other private systems, as indicated below, there are deviations from observance of some of the CPSS Core Principles that may have notable systemic implications. Unless otherwise stated in the following summaries of observance of the Core Principles, the Core Principles are observed in the assessed payment systems. In applying the Core Principles to systems it owns and operates and in its oversight activities, the Bank of Japan largely satisfies its responsibilities within the context of its mandate.

Legal foundation (CP I)

88. The requirement for a sound legal foundation is partly observed for the deferred net settlement mode of the FXYCS, which is the principal mode used, and the Zengin System. Collateral is pledged by participants in both systems to cover the potential systemic risks that could arise in the event of a default by the participant with the largest net debt position. However, under the corporate reorganization laws for financial institutions, stays of execution could be imposed on the liquidation of collateral pledged by a defaulting institution. Under these circumstances, the risk containment arrangements in these systems would be vulnerable to failure with a default by the systems' largest net debtor.

Understanding and management of risks (CPs II–III)

89. Core Principle III, which requires that systemically important systems have rules and procedures for managing credit and liquidity risks that provide incentives for participants to manage and contain these risks, is broadly observed in the deferred gross settlement mode of the BoJ-NET FTS and partly observed in the TCH-BCCS. There are no controls to cover the liquidity risks to surviving participants from a default of a counter party in the cash leg of a non-JGB transaction settled in the deferred gross settlement mode of the BoJ-NET FTS. However, the aggregate value of these transactions is relatively small and the individual surviving participants are in a position to obtain intra-day credit from the Bank of Japan using the non-JGB securities from the failed transaction as collateral. Consequently, there are no significant systemic implications from a participant's default in such transactions. There are also no settlement risk controls in the TCH-BCCS and, in the event of default by a participant, payments would be unwound, which would leave some surviving participants exposed to liquidity and possibly credit risk. In this case, there could be systemic consequences if the defaulting participant were a large net debtor since there would be unwinds of large-value inter-corporate payments and the surviving participants would have no securities collateral associated with the failed transactions.

Settlement (CPs IV-VI)

90. Because of inadequate risk controls in the TCH-BCCS, the Core Principles for prompt and final settlement (CP IV) and the certainty of settlement of a deferred multilateral net settlement system in the event of a default by the participant with the largest obligation (CP V) are non-observed in this system. Because the settlement of the cash leg of non-JGB transactions can be cancelled in the event of a participant's default in the deferred gross settlement mode of the BoJ-NET FTS, CP IV is not fully observed in this system either. However, since the associated collateral available to surviving participants in a failed cash settlement of non-JGB delivery-versus-payment transactions in the deferred gross settlement mode of the BoJ-NET FTS allows ready access to intra-day credit, there would be no systemic consequences of the recalculation of settlement obligations and the associated settlement delays. All the systems settle on BoJ current accounts to satisfy the requirement of CP VI for a virtually riskless settlement asset.

Security and operational reliability and contingency arrangements (CP VII)

91. All systems have adequate back-up arrangements in primary and remote sites and all but the TCH-BCCS have effective business continuity arrangements. The TCH-BCCS has a contingency plan for switching to an off-site manual-entry PC system in the event of a failure of both its primary and back-up systems at its primary site. However, the contingency plans have not been adequately tested nor are the primary and back-up on-site and off-site systems of the TCH-BCCS independently audited.

Efficiency and practicality of the system (CP VIII)

92. All systems with the exception of the TCH-BCCS are efficient and practical systemically important payment systems. The TCH-BCCS is a practical system for participants that provide bill and check payment services to business customers that prefer to utilize these instruments. However, compared to the Zengin System that clears and settles electronic inter-corporate payments, the TCH-BCCS is relatively cost-inefficient and impractical for the large-value and time-sensitive payments that typically characterize systemically important payment systems. The relatively low aggregate volume and value of payments cleared and settled in this system, and the ability to transfer business payments to the Zengin System, limit the broad consequence of the system's comparative inefficiency.

Criteria for participation (CP IX)

93. Access and participation criteria are objective and now publicly disclosed by all systems. In December 2002, the Tokyo Bankers Association, which had already made these public for the TCH-BCCS, decided to make the access and participation criteria for the FXYCS available to the public. In February 2003, they followed the same policy with respect to the criteria for the Zengin System.

Governance (CP X)

94. The governance arrangements in all systems accord with Core Principle X requiring effective, accountable and transparent governance. The systems' operators all have effective communications and well-founded accountability arrangements with participating members and provide public documentation on the role and organization of the systemically important systems. In addition, the Bank of Japan, as a public sector agency, reports publicly on its operational services and policy initiatives and supports a variety of consultation mechanisms with the participants in the BoJ-NET FTS, the private system operators of systems that it oversees, and other public agencies with interests and influence on the payment systems in Japan. Notwithstanding their observance of CP X, the operators of the private systems might consider even greater public transparency regarding their governance arrangements and operating initiatives to enhance the efficiency with which their systems can meet the needs of all users.

D. Central Bank Responsibilities in Applying the CPs

95. The Bank of Japan largely meets its responsibilities in applying the Core Principles to the systems that it operates and oversees. The only notable deviation from full observance of its responsibilities is with regard to the broadly observed assessment of CPs III and IV for the deferred gross settlement mode of BoJ-NET FTS. The Bank's objectives, roles and major policies with respect to systemically important payment systems are publicly disclosed through a variety of media. It cooperates effectively with other central banks, private system operators, principal participants in all the major payment systems and relevant public agencies through a network of consultative and advisory agencies to promote the efficiency and safety of payment systems in Japan. It also monitors and promotes compliance by private operators of the systemically important systems using the oversight and policy tools available to it within its statutory mandate. The Bank continues to develop its oversight function and mechanisms. In moving ahead, it could be even more effective in meeting its responsibilities with respect to the application of the CPs by becoming more proactive in promoting the safety and efficiency objectives inherent to the CPs, using its available instruments, with the appropriate public agencies and the private system owners and operators, especially to redress deviations from full observance of the CPs.

Recommended Actions to Improve Observance of CPSS Core Principles and Central Bank Responsibilities in Applying the CPs—SIPS

Reference principle	***Recommended action***
Legal foundation *CP I – The system should have a well-founded legal basis under all relevant jurisdictions.*	The Bank of Japan should initiate discussions with the relevant parties and ministries regarding the legal changes necessary to protect collateral pledged to the central counterparties of systemically important payment systems from stays on execution.
Understanding and management of risks	
CP III – The system should have clearly defined procedures for the management of credit and liquidity risks, which specify the respective responsibilities of operator and participants and which provide appropriate incentives to manage and contain those risks.	In consultation with the Bank of Japan, the Tokyo Bankers Association should develop effective strategies in the TCH-BCCS to limit settlement risks to surviving participants in the event of a default by another participant. Mechanisms that should be considered include an enhanced settlement fund, a loss-sharing arrangement and a value cap on individual payment items accepted for clearing and settlement through the system.
Settlement	
CP IV –The system should provide prompt final settlement on the day of value preferably during the day and at a minimum at the end of the day.	The Bank of Japan should finalize the schedule for migrating the remaining types of payments processed through the deferred gross settlement mode of BoJ-NET FTS, which has inadequate risk controls for ensuring prompt and final settlement of some types of these payments, to its RTGS mode and implement it according to schedule.

Reference principle	*Recommended action*
Security and operational reliability, and contingency arrangements	
CP VII – The system should ensure a high degree of security and operational reliability and should have contingency arrangements for the timely completion of daily processing.	The Tokyo Bankers Association, in consultation with the Bank of Japan, should design an effective testing program for the primary site and PC-based back-up systems for the TCH-BCCS and institute periodic independent audits of the systems.

E. Authorities' Response

96. Discussions with the FSAP team throughout the mission have provided useful insights about where steps may be taken in order to further strengthen the safety and efficiency of the four systemically important payment systems in Japan. The Bank of Japan's comments on the assessment of compliance with the Core Principles and on the recommended actions follow below.

97. On the recommended action regarding Core Principle I, the risk control arrangements in the Zengin System and the FXYCS have already been introduced so that the legal risk pointed out in the assessment would be effectively contained and mitigated even in the event of default by the participant with the largest net debit position. Specifically, the rules of both systems clearly define loss-sharing and other procedures to be followed by the remaining participants in the event collateral liquidation by the system operator is delayed under reorganization-type insolvency proceedings for the defaulting financial institution[s]. Consequently, in the event stays on execution are imposed on the liquidation of collateral pledged by the defaulting institution, prompt repayment from the Tokyo Bankers Association as the central counterparty to the liquidity-provider banks will be ensured in accordance with these rules.

98. With respect to the recommended action regarding Core Principle III, it should be noted that no practical way exists for the TCH-BCCS, due to its characteristic as a debit transfer system, to satisfy Core Principle III. Although the FSAP team recommends a range of actions, it seems to be virtually impossible to implement them as they are all either too costly or impractical. Meanwhile, the volume and value of bills and checks exchanged through the TCH-BCCS has been decreasing significantly and constantly throughout the decade. It is therefore very likely that the possibility of default by a participant in the system resulting in systemic disruption has become small. Against this background the Bank does not believe that the current risk control arrangements should be changed.

99. Concerning the recommended action regarding Core Principle IV, the Bank will continue to migrate remaining types of payments processed through the *deferred gross settlement* mode of BoJ-NET FTS to its real-time gross settlement mode, in accordance with its schedules such as the one published in April 2001. The Bank, however, does not intend to migrate all the payments settled over current accounts at the Bank to the real-time gross

settlement mode. For certain types of payments which are made to/from the Bank, the *deferred gross settlement* mode is more suited in terms of operational efficiency while not posing any additional risk to the system participants.

IMF Code of Good Practices on Transparency in Monetary and Financial Policies

A. Transparency of Monetary Policies

General

100. The BoJ was assessed on its observance of the monetary policy portions of the IMF *Code of Good Practices on Transparency in Monetary and Financial Policies* (MFP Transparency Code).[5] The assessment of the BoJ's observance of the MFP Transparency Code was based on (1) a self assessment of the Code by BoJ staff and the responses by BoJ staff to a 1999 questionnaire on the Code; (2) review of the *Bank of Japan Law* (BoJ Law) and BoJ publications, including the *Annual Review, Bank of Japan Quarterly Bulletin, Monetary and Economic Studies,* public statements, and statistical releases; (3) review of information contained on the BoJ website (http://www.boj.or.jp); (4) discussions with a range of BoJ officials, including a Deputy Governor and an Executive Director; and (5) discussions with private sector professionals (five from financial institutions and three financial journalists).

Main findings summary

101. Observance by the BoJ with respect to transparency practices in the conduct of monetary policies meets a high standard. A number of provisions in the new *Bank of Japan Law* require transparency by, and accountability of, the BoJ. This serves as an operational and directional guide to the BoJ in the conduct of its policies and activities. BoJ officials at the Policy Board level are supportive of the transparency concept and view transparency as an evolutionary and ongoing process. The BoJ thus is prepared to broaden and strengthen the practice of transparency further and appears receptive to new initiatives in this regard. The BoJ utilizes a combination of means to disclose and explain information (both in Japanese and English) about its policies and activities, including a number of reports mandated by the BoJ Law (e.g., outlines of discussion of Monetary Policy Meetings [minutes] and transcripts of such meetings at a later date, and semi-annual reports to the Diet), the *Annual Review* and the annual "Outline of Business Operations" (in Japanese), press releases, press conferences, public consultations, speeches by its officials, and its website.

102. The Internet has dramatically widened the scope for disseminating information about the BoJ's activities and policies, thereby facilitating efforts to practice more effective

[5] The assessment was conducted by Charles Siegman (former Federal Reserve Board and International Monetary Fund) in June 2002.

transparency. The BoJ has made good use of this communication mechanism, and it is consciously working to build on the progress achieved with it thus far.

103. Meetings with financial journalists and market participants on how the public perceives the BoJ's practice and implementation of transparency added another perspective to the assessment. The private sector professionals confirmed that the BoJ was taking the implementation of transparency practices seriously. On the whole, they were positive about the BoJ's efforts and results in this regard. There was uniform praise for the content and quality of the BoJ's website. These professionals stressed that given the particular unique economic circumstances of deflation, the BoJ's policy stance directed at this condition requires clear exposition and periodic restatement.

104. There is considerable good transparency practiced by the BoJ with regard to clarity of roles, responsibilities, and objectives of monetary policies. Most of these aspects concerning the BoJ are specified in the BoJ Law that took effect in 1998. These elements of the BoJ's mandate are further disclosed, described, and explained in a variety of reports issued by the BoJ, other BoJ publications, and speeches by BoJ officials. Most of these publications and pronouncements are posted on the BoJ's website.

105. The BoJ follows good transparency practices related to open process for formulating and reporting of monetary policies. The advance meeting schedule of the Policy Board for the bi-monthly Monetary Policy Meetings is publicly disclosed in a scheduled manner. The BoJ announces and posts on the Bank's website all monetary policy decisions by the Policy Board (even when there is no change in policy) immediately after each of the two monthly Monetary Policy Meetings, supplemented when there is a monetary policy change by a statement explaining the decision and a special press conference the same day of the decision. Regular press conferences are held by the Governor of the BoJ after the first of the bi-monthly Monetary Policy Meetings. The BoJ publishes minutes of its Monetary Policy Meetings approximately one month after such meetings and releases transcripts of these meetings ten years later. Reasons for monetary policy decisions by the Policy Board are offered in BoJ publications, in speeches by BoJ officials, and in reports to the Diet. The periodic reports that the BoJ issues cover the progress toward achieving its monetary policy objectives and on the evolving macroeconomic situation and their implications for monetary policy.

106. The BoJ observes all of the practices of the Code with regard to public availability of information on monetary policies. Japan subscribes to the IMF's Special Data Dissemination Standards (SDDS). Information about foreign exchange reserve assets, liabilities and commitments by the monetary authorities are disclosed on a pre-announced schedule, consistent with the International Monetary Fund's Data Dissemination Standards. The BoJ maintains effective public information services, and its website, containing both Japanese and English language material, is well-structured, user friendly, and well-maintained. The BoJ has an organized publications program, with increasing attention to the publication of English-language material. It issues a number of reports required by the BoJ Law to be submitted to the Diet and available to the public by specific dates in the year, including a

semi-annual report on the Policy Board's decisions relating to currency and monetary control. In reaching out to a wider public, the BoJ issues primers on a variety of topical subjects related to the functions and responsibilities of the BoJ, and it operates an organized public education program. Texts of speeches by BoJ officials are released to the public and posted on the BoJ's website, and texts of regulations are readily available to the public. The BoJ issues its balance sheet on a pre-announced schedule, and publicly discloses information on its aggregate market transactions. On the day the BoJ decides to make Article 38 loans ("special loans"), the Bank issues a public statement containing the name of the institution. Aggregate information on such special loans is provided by the BoJ in published financial statements, and the two different annual reports (one in Japanese and the other in English) contain further information on the status of such loans.

107. The BoJ meets all of the transparency practices of the Code with regard to accountability and assurances of integrity by the central bank. BoJ officials make numerous appearances before Diet committees and individual Diet members to report on the conduct of monetary policy, explain the Bank's policy objectives, describe the performance in achieving these objectives, and, as appropriate, exchange views on the state of the economy and the financial system. The BoJ releases appropriately prepared financial statements on a scheduled basis. The BoJ discloses information on the expenses in operating the Bank and about standards for the conduct of personal financial affairs of its officials and staff.

108. Given that the BoJ observes or broadly observes the practices of the MFP Transparency Code, the assessment does not call for a recommended action plan to address shortcomings in transparency. At the same time, given that transparency is mandated in the BoJ Law and endorsed at the Policy Board level as a Bank operational principle, BoJ officials should build on what it has achieved in the practice of transparency and introduce over time additional transparency measures where appropriate.

Authorities' response

109. The BoJ found the process very constructive and welcomed the positive assessment by the IMF. As stated in the assessment, the BoJ stressed that it is taking the implementation of transparency practices seriously and finds the implementation of transparency an evolutionary and ongoing process. In this respect, the BoJ pointed out that further efforts have been made since the assessment including publication of its self-assessment report on transparency practices for monetary policy (both in Japanese and in English) in August 2002.

B. Transparency of Financial Policies

General

110. The role of "financial agency" in Japan comprises, for the purposes of this assessment, that of the Financial Services Agency (FSA), the unified regulatory body responsible for the supervision of most financial institutions in Japan, together with its

affiliated body, the Deposit Insurance Corporation (DIC).[6] The assessment also covers part of the activities of the Bank of Japan (BoJ). Certain cooperative institutions, government-owned financial institutions and the Japan Post are the primary responsibility of other government departments, although the FSA assumed a role as inspecting authority of their risk management systems on behalf of the relevant Ministry from April 2003. The BoJ has a more limited function in relation to the soundness of certain financial institutions by virtue of its powers under Article 44 of the Bank of Japan Law (BoJL). This provision empowers the BoJ to contract with its counterparties in the financial markets. These contracts can, and do, include an obligation on the part of the institutions to be examined by the Bank of Japan. However, the BoJ has no powers to license, regulate, or impose penalties or sanctions on the institutions. Such powers reside solely in the FSA. In addition, the BoJ has a responsibility to oversee the functioning of the payment system, including the provision of payment services by private sector organizations.

111. The legal powers of the FSA, and its obligations, stem mainly from the FSA Law (FSAL), and also from provisions in the various laws regulating the authorization etc, of different classes of financial institution. The Deposit Insurance Law (DIL) regulates the DIC and deals with matters relating to the resolution of failing institutions. The BoJ law provides the BoJ with the power to provide payment services and the responsibility to oversee their provision by others. It also authorizes the BoJ to enter into contracts with financial institutions permitting, inter alia, their examination.

112. This assessment covers the responsibilities of the FSA to supervise all categories of financial institutions and markets, together with the BoJ's responsibilities in respect of those institutions with which it has a contractual arrangement involving examinations. It also covers the role of the DIC, and the role of the BoJ as oversight authority with responsibility for the payment system. The assessment was done on the basis of self assessments prepared by the FSA and the BoJ and discussion with officials of both institutions as well as with those of the DIC.

Main findings

113. Both the FSA and the BoJ demonstrate a high degree of transparency. This also applies to the DIC and its subsidiary, the RCC. As noted above in the monetary policy section, the BoJ has a relatively modern statute that demands a considerable degree of transparency and the BoJ, as a matter of policy, is also heavily committed to transparency. The FSA Law itself is not so specific, but, as a government agency, the FSA is also subject to a set of statutes requiring rigorous transparency.

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[6] This assessment was conducted in October 2002 by Peter Hayward (IMF, MFD), Donald McIsaac (lead insurance specialist, Financial Sector Department of the World Bank), and Alan Cameron (former chairman of the Australian Securities and Investments Commission, the Executive Committee of IOSCO, and the Joint Forum).

114. In all cases statutes are modern, kept up to date, and state clearly objectives and responsibilities. Both the FSA and the BoJ produce a wealth of material, including substantive annual reports and other regular documentation, even though not always legally obliged to do so. They also both describe their activities through frequent press conferences and speeches. Senior officials account frequently to the Diet on their activities. The DIC has gone to great lengths to explain the deposit insurance scheme and the extent to which depositors are protected by it.

115. The transparency of the present arrangements has some deficiencies. Although the Commissioner of the FSA is head of the agency and is responsible for its work, on certain aspects the Minister for Financial Services carries responsibility and the division of responsibilities is complicated and not fully transparent.

116. The Minister is a member of the Cabinet and as such serves at the Prime Minister's pleasure. The Commissioner, although protected from dismissal by rules that apply to all government servants, can nonetheless be transferred to other duties at the wishes of the government. No reasons are normally given for such transfers. The appearance of political interference in the FSA's work can thus not be avoided. It is also difficult to ensure that the actions of the FSA, because it is a government agency and has responsibilities that go beyond supervision, are not driven by non-prudential policies.

117. While the FSA has responsibility for all types of financial institutions, its responsibilities in respect of certain government owned financial institutions are new. With effect from April 2003 the FSA will be entrusted with the inspection of the risk management of the Japan Post and certain government-owned financial institutions but the responsibility for any consequent action lies with the relevant government department.

118. There are statutory arrangements for the exchange of information between the FSA and the BoJ. Both institutions do an extensive amount of on-site and off-site supervision. While the results of this supervisory activity is shared, there are statutory barriers to this process and it is not clear whether these are always effectively surmounted, as both organizations are subject to their own confidentiality obligations.

Authorities' response

119. The Commissioner of the FSA, a national public servant, is stipulated as the head of the FSA in the Article 2. 2 of the FSA Law and the authorities for supervision and inspection of financial institutions supervised by the FSA are directly delegated to the Commissioner by the Prime Minister. On the other hand, the Minister for Financial Services, a member of the Cabinet, is stipulated in Article 11 of the CAO Law. According to this article, the minister is in charge of managing the FSA's operations and coordinating the affairs of comprehensively developing an environment for smooth financing among relevant ministries and agencies. Therefore, the division of the roles of the Minister and the Commissioner are clarified in the respective laws and transparency is fully secured.

120. The staff points out the appearance of political interference in the FSA's work. However, in a democratic country, it is a matter of course that administration has a certain degree of relationship with politics. In this respect, Japan is not an exception. However, we do not believe that the situation in Japan is so different from other developed countries.

121. In Japan, the roles of the Commissioner of the FSA and the Minister for Financial Services are clearly stipulated in their respective relevant laws and are clearly divided in order to secure the autonomy of the FSA to the greatest extent possible, as the authorities for supervision and inspection of financial institutions are delegated to the Commissioner, not to the Minister, directly by the Prime Minister. Moreover, the Commissioner has the power of appointing staff. Further independence from the Cabinet means that the FSA should transcend democratic control based on the Constitution.

122. Since the role of the FSA is not only to make prudential policy but also to ensure the smooth functioning of the financial system, as is clearly stipulated in the FSA Law and other relevant laws, the FSA observes the IMF transparency code. Therefore, to undertake non-prudential policies does not denigrate the integrity of the FSA as a supervisor.

123. While the authority to inspect/supervise government owned financial institutions (GFIs) belongs to their regulatory ministries, the authority to inspect risk management processes has been delegated to the Commissioner of the FSA by amendment of the relevant laws. Therefore, although the staff points out that the responsibilities of the FSA and other regulatory ministries for GFIs are not clearly divided, segregation of their roles is clarified and transparency is fully secured.

124. The FSA and the BoJ effectively share necessary information subject to the confidentiality obligation of each as needed based upon relevant laws such as the Bank of Japan Law, Article 44. We believe that there is no problem in transparency and practical operations for the exchange of information, although the staff points out the lack of clear and transparent arrangements for information exchange. The staff also states that "there are statutory barriers to this process and it is not clear whether these are always effectively surmounted". It is true that information reported by financial institutions is not automatically shared among relevant authorities because each authority must obey its own confidentiality obligations. However, relevant authorities exchange information including that related to financial crisis management as needed under their obligations. Therefore, we believe that these exchanges are working well and do not think that any statutory barriers exist which prevent effective exchange of necessary information.

FINANCIAL SYSTEM OVERVIEW

A. Institutions

Banking system

1. **The bank-centered Japanese financial system is still large compared with the size of the economy**. The public sector also plays a much larger role in financial intermediation than in any other major OECD country, with Germany a distant second. Partly as a result, bank profitability is low. Japanese banks rely significantly on collateral, primarily real estate. Despite mergers among major banks, there has been little consolidation in the form of well managed banks acquiring weaker banks with limited franchises as has happened in virtually all other major countries.

2. **While deregulation has been extensive, the banking sector is more fragmented than in other G-7 countries.** The major banks, including the trust banks, account for about 27 percent of total financial system assets, or one-third if government owned financial institutions are excluded (Table 1).[1] The Japanese financial system was designed to be bank centered, and has largely remained so even though the Japanese equity market is the second largest in the world and the corporate bond market is expanding from a low base.

3. **Structural cross-shareholdings and other relationship-based shareholdings are extensive, but have been declining.** As of end-March 2002, financial institutions and non-financial corporations were the two largest shareholders for the major financial groups (banks, insurance companies, and securities firms) (Table 2). Cross-shareholdings have often been used as a way of maintaining or expanding financial relationships with financial institutions and business companies. However, in response to legislation limiting banks' exposure to equity risk and the introduction of mark-to-market accounting, banks and other financial institutions have been reducing their equity portfolios.[2] By March 2003, the major banks had, on average, reduced their equity holdings close to 100 percent of Tier-1 capital compared to 150 percent in March 2002.

4. **Following a series of mergers in the 1990s, the major banks are now down to five banking groups, with two independent trust banks.** Although these groups are very large in terms of assets, other indicators such as the number of customers, branches, and employees, suggest that the major Japanese banks are not so large when compared with

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[1] Trust banks invest customers' funds but also perform conventional banking business. Since the "Big Bang" reforms many have become subsidiaries of commercial banks but two large trust banks remain independent.

[2] In November 2001, the Diet enacted a law forbidding banks from holding stocks in excess of their Tier I capital after September 30, 2004, although it is now proposed to extend this deadline.

major banks from other industrial countries, despite the mergers that have taken place in recent years. Their market share is relatively small because of the existence of many regional banks. Most regional banks benefit from the lower minimum capital requirement of 4 percent that applies to domestically-oriented banks, as opposed to the 8 percent capital requirement for internationally active banks. In addition, there is a variety of smaller, specialized players in the banking market. Foreign banks in Japan, although numerous, have a relatively small presence.

5. **Loans to small- and medium-sized enterprises, albeit declining somewhat, still account for about half of total bank lending** (Table 3). The share of loans to small and medium-sized enterprises has fallen steadily since 1997 while that for lending to individuals and large corporations has increased. Banks' lending to the four troubled sectors—construction, wholesale and retail, real estate, and other financial institutions—represents about 40 percent of total loans.

6. **After rising steadily during 1997–2001, the ratio of nonperforming loans to total loans for some deposit-taking institutions declined in the latter half of 2002**. For the city banks in particular, such assets, net of provisions and as a proportion of capital, have increased sharply, reflecting in part the results of the September 2001 special inspection. At end-September 2002, city banks' outstanding nonperforming loans, after provisions, amounted to 54 percent of their total capital and exceeded their level of Tier-1 capital. However, since then, the major banks' gross nonperforming loan ratio has declined and in the year ending March 2003, fell to 7.2 percent of total loans.

7. **Although Japanese banks' operating profits have been low for the past decade, reported capital adequacy remains above the regulatory minimum** (Tables 4 and 5)**.** After taking account of increases in loan losses and provisions, Japanese banks recorded a loss of ¥6.5 trillion for the year ending March 2002.[3] Interest income continued to be the main contribution to gross income, while the share of fee and trading income has increased somewhat. Despite deregulation and the pressure on banks to increase lending spreads to cover loan losses, spreads remain largely unchanged. Capital adequacy as of end-September 2002 disclosed by the 20 internationally active banks (mostly city banks, some trust banks, and a few regional banks) remained above 8 percent, while the capital adequacy ratios for domestic-oriented banks was well above the 4 percent minimum, with the majority above 8 percent. At end March 2003, the capital ratio for Resona Bank, a major domestic banking group, fell short of the minimum, triggering prudential intervention.

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[3] For the subset of major banks in the year ending March 2003, net losses amounted to around ¥4.4 trillion (on a non-consolidated basis).

Public sector financial intermediation

8. **The public financial sector, including the Japan Post, plays a significant role in financial intermediation in Japan.** The Postal Services Agency (PSA) was reorganized into the Japan Post in April 2003 and is expected to continue providing existing financial services without any major changes. The Japan Post—the largest deposit-taker in the world—takes deposits, and offers payment services and life insurance products in addition to mail services. It has an extensive network of more than 24,000 offices, accounting for 37 percent of all outlets in Japan providing banking services. Postal savings represent almost 25 percent of total deposits in Japan while the postal insurance sells about 15 percent of all life insurance products held by individuals.

9. **The Government Financial Institutions (GFIs) have a large share in the markets for mortgage lending and loans to SMEs and large corporations.** There are ten GFIs, which are fully state-owned with one exception (the Shoko Chukin Bank); nine of them are specialized lending institutions. By far the largest GFI is the Government Housing Loan Corporation (GHLC), which has a 30–40 percent market share in mortgage loans. Two GFIs together have 19 percent of the share in loans to large companies. Three GFIs provide loans to small-and-medium-sized enterprises (SMEs). Another GFI, the Japan Small and Medium Enterprise Corporation, reinsures guarantees of SME loans originated by private sector financial institutions. When direct lending and guarantees to private lending are combined, the public sector accounts for about 20 percent of all loans to SMEs.

10. **The Fiscal Investment and Loan Program (FILP) has traditionally provided a mechanism for channeling funds collected by the PSA and other sources to public agencies on a long-term basis.** Postal savings and postal life insurance collected by the PSA and pension funds have traditionally been channeled through the FILP with assets totaling ¥432 trillion (86 percent of GDP) as of March 2002. The users (the "FILP agencies") include the GFIs, special public corporations, and local governments. Although the FILP reform in April 2001 abolished the compulsory transfer from the PSA, its successor, the Japan Post, still holds about 80 percent of its assets in domestic bonds, and this proportion is expected to fall only gradually.

11. **Public sector financial institutions are exposed to an asymmetric interest rate mismatch.** Until April 2001, the postal savings system deposited most of its funds with the Trust Fund Bureau Fund (TFBF) for seven years at a fixed rate set around the 10-year JGB rate. On the liability side, a large part of the Japan Post's liabilities consist of *teigaku* deposits which offer a fixed deposit rate for up to 10 years with a free option of withdrawing after 6 months, thus allowing depositors to benefit from higher rates when interest rates rise.

12. **Plans are in place or under way to reform the Japan Post, the FILP and the GFIs and to introduce a new role for the FSA.** The newly created Japan Post aims to improve transparency and efficiency by introducing a new business plan and new management. The FILP reform aims to impose greater market discipline on FILP agencies while reducing the fiscal costs. The GHLC will be reorganized by FY 2006 into an

independent administrative agency securitizing housing loans originated by the private sector lenders. Reform of the remaining eight GFIs has been delayed. Unlike the private sector, the public sector financial institutions are not regulated by the FSA. The Japan Post is regulated by the Ministry of Public Management, Home Affairs, and Posts and Telecommunications while the GFIs are regulated by the MoF and other ministries. Legal amendments in May 2002 have enabled the supervisory ministries of the GFIs to delegate the inspection of risk management of the GFIs to the FSA from April 2003.

Insurance

13. **The insurance sector in Japan represents an important part of the financial system.** Reserves representing insurance company obligations to policyholders amount to 38 percent of GDP and equal 25 percent of retail deposits with the banks. This is the second largest insurance sector in the world (after the United States) and insurance purchases in Japan exceed those in the United States in terms of premiums per capita and premiums as a percentage of GDP. Japanese insurance companies have in the past played a major role in funneling household savings to the industry sector and the government, and roughly 95 percent of households have life insurance policies. The largest single insurance business is the postal insurance system ("Kampo") conducted by the Japan Post. The postal insurance system is one of the biggest life insurance systems in the world, with total assets related to its insurance business of ¥126.6 trillion. In comparison, the combined assets for all private Japanese life insurance companies aggregate ¥143.6 trillion.

14. **The industry is shrinking slowly.** The size of the insurance industry has been decreasing slowly for the past two decades. Profit margins have narrowed, particularly for life insurance companies, leading to reductions in dividends to policyholders. The decline is attributable mainly to reductions in investment income and the sharp fall in the values of securities. These factors have also led to a weakening in the capitalization of the companies. Demographic trends may accelerate the shrinking process.

Pension funds

15. **Including the recent introduction of 401k-style plans, the Japanese pension system has all three pillars recommended as protection against the risks of poverty in old age.** A modest basic national pension is available to all citizens who maintain contributions; company workers and civil servants also contribute to a public earnings-related program, which in many cases is supplemented by a company add-on scheme. Although a market for private pension plans exists, it is small.

Securities firms

16. **Since the bursting of the bubble in 1990, the securities industry has experienced a large turnover of firms amid structural changes**. Although since 1990 the number of securities firms has remained fairly constant at around 290, 112 companies have left the market either through mergers or discontinuation, while 114 new companies have been established. Deregulation has led to new entrants in the market, raised the level of

competition, and introduced new products. The industry was deregulated starting in the mid-1990s under the so-called “Big Bang” initiative. The aim was to promote new market entry into the financial industry and remove restrictions on the business scope and organization of financial institutions. As a result, major domestic banks, foreign financial institutions, and Internet-based securities firms have entered the market and gained market share. The ability of Japanese securities firms to compete internationally is constrained by the decline in profitability of their domestic business. Currently, none of Japan’s big three securities firms ranks in the top 15 in underwriting outside of Japan.

B. Markets

17. **The short-term money market comprises mainly the call market, euroyen market, and foreign exchange swap market.** The call market is used for the final adjustment of daily cash balances, much of it overnight, and is influenced by the money market operations of the BoJ. Low interest rates under the BoJ’s quantitative easing program have sharply dampened market activity by making it not worthwhile investing surplus funds in the market. Banks have largely ignored the market in favor of holding current account balances as excess reserves at the BoJ. In some cases, banks have even preferred to lend to other banks at negative interest rates. As a result, the interbank market has become thin, and the BoJ has emerged as one of the main suppliers of liquidity. The decline in activity has also reduced turnover in other markets such as for futures.

18. **Reflecting the rapid rise in government debt, the market for Japanese government securities is now the largest in the world.** In September 2002, the outstanding volume of Japanese government securities, including bonds (JGBs), reached ¥467 trillion, accounting for around 30 percent of government securities issued by OECD countries. Despite the rapid growth in supply, the market has so far been able to absorb the increase in volume mainly by tapping the large pool of households deposits via private and public financial institutions. The JGB market is concentrated with the government and private financial institutions holding 37 percent and 43 percent of JGBs respectively—significantly higher than in the U.S. or Europe. The government has embarked on a reform program to improve the structure and liquidity of the JGB market, such as creating benchmarks around key maturities and introducing a real-time settlement system.

19. **Despite its recent growth and improvements to its infrastructure, the corporate bond market in Japan remains relatively small.** A number of reforms have been implemented to strengthen the corporate bond market, including measures to deregulate bond issuances and improvements to the settlement system. Partly as a result, the total amount outstanding of corporate bonds (excluding asset-backed securities) has grown rapidly since 1991 reaching ¥58 trillion in September 2002, but this is still small compared to ¥430 trillion in outstanding bank loans and ¥467 trillion in government securities. Reasons cited for the relatively small size of the bond market include the main banking system model and the strong presence of the GFIs in the long-term corporate lending market.

20. **Activity in the foreign exchange markets has increased in recent years, reflecting the rise in FX swaps as a channel for investing and raising short-term funds.** Japanese banks have increasingly used FX swaps as a means of funding their FX assets while foreign financial institutions have actively used FX swaps for yen funding.

21. **Of the five stock exchanges in Japan, the largest is the Tokyo Stock Exchange (TSE) with a market capitalization of about ¥232 trillion as of end-March 2003.** In addition to the exchanges, stock trading is done in the JASDAQ market (an OTC market managed by the Japan Securities Dealers Association (JSDA)), over a proprietary trading system, and in off-exchange trading sites for listed stocks. Following the deregulation of the equity markets in the mid-1990s, foreign ownership and activity have risen sharply. The share of household investors has remained fairly stable at around 20 percent while ownership by financial institutions and corporations has fallen reflecting in part the unwinding of cross-shareholdings and a desire to reduce equity risk exposure following the move to marking-to-market of equity holdings, as well as the prospective imposition of limits on banks' equity holdings.

22. **The collapse of the asset price bubble and a large overhang of unsold property still weigh heavily on the real estate market.** Land prices fell by an average of 6.4 percent in 2002—its 12th straight year of decline. As a result of the extensive use of land as collateral for bank lending, the collapse in real estate values has had a detrimental impact on bank and corporate balance sheets. Although some urban areas such as in central Tokyo have shown signs of recovery, concerns are growing over the "2003 office problem" as a large supply of redeveloped commercial property enters the market.

C. Infrastructure

Payment and securities systems

23. **The non-cash payments infrastructure comprises four main inter-bank clearing and settlement systems.** The BoJ-NET Funds Transfer System (BoJ-NET FTS), operated by the BoJ, accounts for around 65 percent of the aggregate value settled. The Domestic Funds Transfer (Zengin) System, owned and operated by the Tokyo Bankers Association (TBA), settles about 9 percent of the aggregate value but accounts for 94 percent of the payment volume over the four systems. The Foreign Exchange Yen Clearing System (FXYCS) is operated by the BoJ under a contractual arrangement with the TBA and accounts for about 24 percent of the aggregate settlement value of the four inter-bank systems. Finally, the Tokyo Clearing House Bill and Check Clearing System (TCH-BCCS), operated by the TBA, settles due bills of exchange and checks. Although some payments still settle on a deferred gross basis in BoJ-NET FTS, to reduce systemic and other risks, real-time gross settlement (RTGS) is now the principal settlement mode for funds transfers over the BoJ's current accounts.

24. **There are central securities depositories (CSDs) for JGBs and other securities and stocks.** JGB transactions are settled on a real-time delivery-versus-payment (DVP) basis

through the BoJ-NET JGB Services. Transactions in stocks deposited at the Japan Securities Depository Center (JASDEC) are settled on a book-entry basis, and DVP is available for stocks traded through exchanges. Non-JGB bonds such as corporate bonds and municipal bonds are registered and transferred on the books of a number of registration agencies (generally banks). Settlement of registered bond transactions are processed on a DVP basis. In March 2003, the JASDEC introduced a book-entry system, including dematerialization, online settlement processing, and DVP for commercial paper transactions. A unified central counterparty for exchange and JASDAQ stock market transactions started operations as of January 2003.

Safety nets

25. **There is an extensive system of safety nets supporting the Japanese financial system.** The current arrangements, which have been subject to a number of changes during and after the crisis of 1997–98, involve the FSA, BoJ, DIC, RCC, and the MoF.

Lender of last resort

26. **The BoJ law was amended in 1997 to clarify the BoJ's "lender of last resort" (LOLR) function.** The law now specifies the "last resort" function as a BoJ objective in Article 1 of the Law. Article 38 prescribes: "The Prime Minister and the Minister of Finance may request that the Bank of Japan conduct the business necessary to maintain an orderly financial system, including provision of loans, when it is believed to be especially necessary for the maintenance of an orderly financial system." Since the financial crisis of the 1990s, the BoJ has advanced money to a number of failing institutions.

Deposit insurance scheme

27. **Japan has a deposit insurance scheme under the Deposit Insurance Law.** The scheme is administered by the DIC, established in July 1971, and subject to oversight by the MoF and the FSA. The scheme covers specified liabilities of all deposit taking institutions, except agricultural and related cooperatives which belong to a separate scheme. Coverage is relatively high at ¥10 million per depositor per institution. The scheme covers all yen deposits in Japanese offices of deposit-taking institutions, other than the postal savings deposits of the Japan Post and deposits of the Shoko Chukin Bank, which is the only deposit-taking GFI. In 1996, the law was amended so as to cover for a five year period, all deposits, irrespective of amount, in order to ensure confidence in the banking system. In March 2001, coverage for time deposits was extended by one further year, and coverage for current and demand accounts was extended by two years. In 2003, coverage of demand deposits was extended for a further two years, with coverage of non-interest bearing deposits in specific so-called "settlement" accounts continuing indefinitely.

28. **The scheme is running a deficit.** The very large failures of the late 1990s led to the exhaustion of the fund and its replacement by a deficit which has reached some ¥3.4 trillion. As a result, any operation by the DIC automatically involves an increase in the fund's borrowing which is in the form of government guaranteed loans from the BoJ or from

financial institutions in the market or by the issue of government guaranteed bonds. Premium rates are now 0.09 percent in respect of "specific deposits", that is those deposits still covered by the full guarantee, and 0.08 percent in respect of other deposits, e.g., time deposits now only insured up to ¥10 million per depositor. These rates were last adjusted with effect from April 2003.

Procedures for dealing with failing and failed banks

29. **A set of procedures for dealing with failing and failed banks is administered by the FSA but in which the DIC, the RCC (a subsidiary of the DIC), the Bridge Bank of Japan, and the BoJ also play a role.** Three very large institutions failed in 1997/98 and a number of smaller institutions failed thereafter. In most cases, with the help of the blanket guarantee, these cases have been dealt with by various forms of purchase and assumption transactions whereby other institutions have assumed the deposit liabilities and acquired the "good" assets and remaining assets have been transferred to the RCC. The powers of the FSA to resolve failed banks were enhanced through an amendment to the Deposit Insurance Law in May 2000 authorizing the Commissioner of the FSA to appoint a financial administrator with full powers to deal with the business of the bank, including disposing of its assets and liabilities pending a final resolution.

Financial crisis management framework

30. **To enhance confidence in the financial system the Deposit Insurance Law was amended in May 2000 to establish an explicit crisis management framework.** Under the so-called "systemic risk exception," the Law provides that if the potential failure of a financial institution poses a serious threat to the stability of the financial system, the Prime Minister can summon a meeting of the Financial Crisis Council under his chairmanship. The council consists of the Chief Cabinet Secretary, the Minister of Finance, the Minister for Financial Services, the Commissioner of the FSA, and the Governor of the BoJ. On the advice of the Council, the Prime Minister can invoke the provisions of the law and authorize the DIC to either: (i) inject capital into one or more financial institutions; (ii) provide financial assistance to an institution in excess of that mandated under the deposit insurance scheme; or if necessary, (iii) take over control and acquire the share capital of a financial institution.

31. **To back up these arrangements the government has committed ¥15 trillion for the support of banks in the event of a threat to the system.** This facility, together with the advance commitment of funds, has been taken by the market to mean that the five largest banking groups can be regarded as "too big to fail". The arrangement was tested in the recent Resona case, which demonstrated that, in close coordination with the BoJ, the arrangements were effective. The authorities believe the amount available is sufficient to ensure the stability of the financial system. The Financial System Council, an advisory body to the FSA, is also reportedly considering a new system that would allow for preventive injection of public funds, even in cases where banks meet minimum regulatory capital requirements.

BoJ Equity Purchases

32. **A recently established BoJ equity purchases scheme is intended to contribute to financial stability.** The BoJ offers to purchase, off the market, some of the equity holdings that banks will have to sell if they are to meet the limits that will be imposed from October 2004. These supplement the arrangements for purchases by a government scheme for which the conditions proved too restrictive for much use to be made of them.

D. Supervision

Institutional aspects

33. **The supervisory framework has recently been substantially changed with the setting up of the FSA (see box below).** The FSA law provides for on-site and off-site supervision of all authorized financial institutions by the FSA. Legislation also provides for a minister for financial services, who is a member of the cabinet and has effective authority over the FSA. The FSA law authorizes the FSA to prescribe prudential rules and to apply sanctions where the rules are not complied with, or where an authorized institution is regarded as unsafe or unsound.

34. **While the FSA has inherited the function of the MoF as statutory regulator of financial institutions, most major financial institutions are also subject to supervision by the BoJ.** The Bank claims this right as a part of the contract that it agrees with each of the financial intermediaries with whom it deals in the markets. These contracts entitle the BoJ to carry out supervision both on- and off-site in order to establish the soundness of these institutions. However, the BoJ is not the statutory regulator and has no formal powers to require the institutions it examines to implement its examiners' findings. Although originally non-statutory, the BoJ law, as amended in 1997, now contains a provision enabling the BoJ to require financial intermediaries with whom it deals to enter into such a contract. The BoJ also has oversight responsibility for payment systems.

Prudential rules

35. **Minimum capital requirements are designed to conform with the Basel Accord.** The FSA has no freedom to vary minimum capital requirements in accordance with its relative risk assessment but in 2002 introduced an early warning mechanism providing for intensive monitoring for banks that are above the required minimum capital but exhibit particular risk characteristics. However, the composition of capital, while built upon the Basel framework, is over-reliant on preferred shares and deferred tax assets, and several large groups lack sufficient ordinary shareholders' funds.

36. **The FSA has established new procedures for the classification of borrowers and of assets.** Each claim is classified in two dimensions, by borrower and by type of claim (principally the type of collateral). Provisions are raised against uncollateralized loans. Provisions can be deducted from income for corporate tax purposes to a limited extent only. None of deferred tax assets are deducted from capital for capital adequacy purposes, but the

Financial Services Agency: History, Responsibilities, and Current Organization

Until the creation of the Financial Supervisory Agency, banking and insurance supervision was carried out by the Banking Bureau of the Ministry of Finance. Securities firms were supervised by the Securities Bureau and compliance with foreign exchange regulations was handled by the International Finance Bureau. Shinkin banks were, however, not handled by the Banking Bureau but by Local Finance Bureaus (LFBs) of the Ministry of Finance in each prefecture, while credit cooperatives were regulated by each prefectural government. With the setting up of the Financial Supervisory Agency, the functions of the Banking Bureau and the Securities Bureau were transferred to the Financial Supervisory Agency. The LFBs then became, to the extent of their supervisory responsibilities, answerable to the Financial Supervisory Agency, although the staff is still employed by the MoF. The regulatory functions that used to be exercised by the International Finance Bureau were also transferred to the Financial Supervisory Agency and the Bureau was renamed the International Bureau. It no longer has any dealings with individual financial institutions.

When the Financial Supervisory Agency was first established in 1998, it worked in conjunction with the MoF Financial Policy Bureau and the Financial Reconstruction Commission. But as a second stage to the reforms, when the Financial Supervisory Agency was renamed Financial Services Agency (FSA), the Commission was abolished in January 2001 and the residual functions dealing with the financial sector were transferred to the FSA; only a small Financial System Stabilization Division remains in the secretariat of the Minister of Finance.

The MoF style of supervision was almost entirely compliance geared, so there was little off-site monitoring or other regular contact with supervised institutions. Banks and regulated entities were subject to periodic inspection. These inspections were designed to ensure that regulated entities complied with the law and that their financial statements were produced in accordance with MoF guidance. This guidance extended to the assessment of asset quality and provisioning. Bank of Japan supervision was more risk based. There was, and is, an understanding between the two agencies coordinating examinations. Under the FSA, off-site supervision has developed and although this function is organizationally separate from the inspection function, the two functions are integrated.

The FSA inherited the staff of the relevant parts of the MoF, including its examination staff. The senior staff of the MoF were subject to a rigorous transfer procedure which ensured that civil servants rarely worked in the same area for long. To some extent, this still persists and staff is regularly transferred between the FSA and the MoF. The FSA staff has grown dramatically, and has now reached about 1,000, with a further 1400 in LFBs of the MoF working on supervision. Although the core examination staff have long experience, many new recruits have been added, including a few with commercial banking experience. The FSA has also begun the process of training the LFB staff in modern supervision techniques. About 800 staff are involved in off-site supervision, of which some 640 are in LFBs. Staff turnover is low. Salaries are competitive with salaries in banks and, in any case, public servants are not allowed to work for institutions with which they have had a regulatory relationship for two years after leaving the service.

The FSA is responsible to a member of the cabinet. Although some distinction is drawn between the role of the Minister for Financial Services and the Commissioner of the FSA, the Minister has effective management control over the FSA. All significant reports on individual banks are referred to him. He is a member of the Cabinet and is answerable to the Diet for legislative matters in the way that ministers of finance are in most countries. The management of the FSA is, however, still the responsibility of the Commissioner and his staff. There is no Board or other form of collegiate decision making body.

The FSA is divided into three bureaus, Planning and Coordination, Inspection, and Supervision. There is also a Securities and Exchange Surveillance Commission, whose staff is, within the FSA, responsible for the surveillance of securities and futures markets. The Planning and Coordination bureau is responsible for the administration of relevant laws, including the deposit insurance law. The FSA has inherited the MoF's responsibility for the examination and supervision of the accounting profession and for the maintenance with the JICPA of accounting and auditing standards, not just for financial institutions but for the system as a whole. Similar arrangements apply to the supervision of insurance companies, securities firms and other financial institutions which are subject to the supervision of the FSA. Government financial institutions and agricultural credit cooperatives are not subject to the supervision of the FSA but by their sponsoring ministry. Since April 2003, the FSA has been delegated certain powers to inspect the risk management processes of some of these institutions.

Financial System Council is considering the appropriate treatment. Large exposures are limited to 25 percent of capital per customer. To a group of related customers, exposure can reach up to 40 percent. Exposures to shareholders are restricted to 15 percent of capital and to shareholders and related parties to 25 percent of capital. The large exposure limits are somewhat higher than those suggested by the Basel Committee. Many OECD countries require banks to be even more restrictive.

37. **While both FSA and BoJ do on-site examinations, the supervisors also make some use of external audit reports**. Inspections take place once a year for major banks, and although there are no rules for the frequency of inspections of smaller banks, in practice all of them have been inspected twice in the years the FSA has been in existence. For major banks, the FSA in 2002 introduced an arrangement whereby inspectors are continuously assigned to major banks throughout the year. Consolidated supervision is now practiced; and the FSA has powers to examine holding companies, and also shareholders who hold more than 20 percent of a supervised institution. The FSA works closely together with a bank's external auditor, but the auditor has no obligation to inform the FSA of problems he comes across during audit work.

38. **The FSA has powers to revoke a banking license and the law provides a mandatory "prompt corrective action procedure" where banks fail to meet minimum capital requirements.**[1] The FSA can prevent a bank from paying dividends and has powers over the appointment of managers and directors. Shareholders who acquire more than 5 percent of a bank's equity must notify the FSA and the acquisition of more than 20 percent requires FSA approval. The FSA has powers to share information with foreign supervisory authorities for supervisory purposes.

[1] "Prompt corrective action procedures," first established in the U.S. and now used in several other countries, are legal requirements that force the supervisor to take specified actions when trigger thresholds are reached. These requirements are intended to limit opportunities for supervisory forbearance.

Table 1. Japan: Financial System Structure, end-March 2002 (Fiscal 2001) 1/

	Number of			Total assets			Deposits outstanding		Loans and disc. outstanding	
	Institutions	Branches	Employees	Amount (trill. yen)	(% of Total)	(% of GDP)	Amount (trill. yen)	(% of Total)	Amount (trill. yen)	(% of Total)
Private depository institutions										
Banks										
City banks (consolidated)	7	2,853	104,847	410	20.9	81.9	260	23.5	238	27.6
Long-term credit banks	3	39	4,131	53	2.7	10.6	10	0.9	27	3.1
Trust banks	29	405	28,266	67	3.4	13.4	33	3.0	41	4.8
Regional banks	64	7,788	141,237	206	10.5	41.1	181	16.4	136	15.8
Regional banks II	53	3,873	59,830	60	3.1	12.0	55	5.0	43	5.0
Foreign banks	73	112	4,993	50	2.6	10.0	10	0.9	12	1.4
Others 2/	5	4	303	0.4	0.0	0.1	0.2	0.0	0.0	0.0
Cooperative financial institutions										
Shinkin banks and Shinkin Central Bank	350	8,416	131,401	137	7.0	27.4	120	10.9	74	8.6
Credit cooperatives and National Federation	205	1,950	23,234	19	1.0	3.8	16	1.4	10	1.2
Labor credit associations and Rokinren Bank	22	689	11,439	17	0.9	3.4	15	1.4	8	0.9
Agricultural cooperatives and Credit federations	1227	-	-	147	7.5	29.4	123	11.1	26	3.0
Fishery cooperatives and Credit federations	638	-	-	4	0.2	0.8	3	0.3	1	0.1
Others 3/	2	142	7,635	70	3.6	14.0	40	3.6	35	4.1
Non-depository financial institutions										
Insurance companies										
Life	43	15,807	380,864	184	9.4	36.7	...	...	47	5.5
Nonlife	59	4,869	87,501	33	1.7	6.6	...	...	4	0.5
Securities companies	290	2,249	94,464	65	3.3	13.0	...	...	...	...
Money market dealers	3	7	434	30	1.5	6.0	...	...	...	...
Others 4/	27,684	...	...	...	...	...	...	...	...	...
Public financial institutions										
Postal savings	1	24,773	62,422	242	12.3	48.3	239	21.6	0.7	0.1
Government financial institutions										
Development Bank of Japan	1	25	1,390	18	0.9	3.6	...	...	17	2.0
Japan Bank for International Cooperation	1	29	893	23	1.2	4.6	...	...	22	2.6
Finance corporations	6	257	8,967	125	6.4	25.0	...	...	120	13.9
Total financial system (excl. Bank of Japan)	30,766	74,287	1,154,251	1,960	100.0	391.4	1,105	100.0	862	100.0
Memorandum item:										
City banks' international operations										
(in percent of consolidated assets)	...	141	...	83	21.4	...	31	12.3	26	11.4

Sources: Japanese Bankers Association "Analysis of Financial Statements of all banks", MoF, Postal Services Agency, Shoko Chukin Bank and FSA.

1/ As of end-March 2002 for banks and as of the latest available date for other institutions.

2/ Includes one new bridge bank and new types of banks such as internet banks.

3/ Includes the Shoko Chukin Bank and the Norinchukin Bank.

4/ Includes consumer credit institutions, securities finance companies, and securities investment trust management companies.

Table 2. Japan: Ownership Structures of Major Institutions in the Financial Sector 1/

(Ownership share in percent, end-March 2002/Fiscal 2001)

	Local and Central Government	Financial Institutions	Securities Firms	Non-financial Corp.	Foreign Corp. and Individuals	Other Individuals
Major financial groups	0.1	37.3	1.7	41.1	8.6	11.3
Mizuho Holdings	0.1	49.1	1.2	33.1	6.5	10.0
MTFG	0.1	45.9	0.8	34.1	12.7	7.1
SMBC	0.1	38.8	1.7	38.4	11.3	9.8
UFJ	0.0	39.2	1.8	43.2	5.9	9.9
Resona	0.2	27.6	2.1	42.5	5.5	22.2
Mitsui Trust Holdings	0.0	23.9	2.9	56.3	1.9	15.1
Sumitomo Trust	0.0	36.8	1.3	40.5	16.6	4.8
Major life insurers 2/						
Daido	0.0	18.2	0.6	60.8	7.9	12.5
Major non-life insurers						
Tokio Marine & Fire	0.0	46.4	1.3	9.9	23.6	18.7
Yasuda Fire & Marine	0.0	49.0	0.7	11.1	22.5	16.7
Mitsui Sumitomo	0.0	33.9	0.6	18.0	32.3	15.3
Nipponkoa	0.0	44.4	0.2	16.2	28.7	10.5
Aioi	0.0	24.8	1.5	40.6	18.3	14.7
Nichido Fire & Marine	0.0	47.1	2.9	15.3	26.9	7.8
Fuji Fire & Marine	0.0	21.0	1.7	38.8	26.8	11.6
Nissay Dowa	0.0	72.8	0.6	11.7	5.5	9.5
Nissan Fire	0.0	24.1	1.2	32.9	33.9	7.9
Nisshin Fire & Marine	0.0	62.9	0.5	14.0	1.9	20.8
Major clearing houses and market makers						
Tokyo Stock Exchange 3/	0.0	0.0	100.0	0.0	0.0	0.0
Nomura Holdings	0.0	42.2	0.6	9.5	28.3	19.4
Nikko Holdings	0.0	28.2	0.9	6.8	49.8	14.4
Daiwa Securities Group	0.0	47.2	0.6	7.0	29.4	15.9

Sources: FSA, individual institutions' financial disclosures.

1/ These are based on disclosed information on ownership of common stocks by type of shareholders. Shares in trust accounts are included.
2/ Of the top 10 life insurers, Daido is the only listed joint stock company; the other nine insurers are mutual life companies, owned by policyholders.
3/ These are subscriptions by member securities firms, some of which are owned by major financial groups.

Table 3. Japan: Asset Composition and Quality, Domestic Banks, 1997–2002
(In percent, end of March, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	Sept. 2002
Total loans and discounts outstanding (in trillions of yen) 1/	512	514	503	493	475	447	429
Sectoral distribution of loans to total loans 1/							
Individuals	17.4	17.8	18.5	19.1	20.2	22.2	23.4
Local governments	1.4	1.6	1.9	1.8	1.8	2.2	2.2
Manufacturing	14.3	13.8	14.1	14.8	14.6	14.2	13.9
Non-manufacturing	65.6	65.3	64.2	63.3	62.4	60.2	59.6
of which:							
Construction	6.2	6.2	6.4	6.3	6.1	5.7	5.4
Wholesale, retail, and restaurants	15.4	15.2	15.2	15.2	15.0	14.2	13.9
Finance and insurance	10.1	10.0	9.5	9.1	8.8	8.8	8.5
Real estate	12.4	12.7	12.9	12.6	12.5	12.4	12.3
Memorandum item							
Small and medium enterprises (incl. finance and insurance)	51.4	50.5	49.3	46.8	49.4	48.2	46.5
Total external claims as a percent of total assets	11.3	12.1	11.2	9.1	10.0	10.2	…
Geographical distribution of external claims							
Developed countries	34.8	40.9	52.0	55.7	62.8	63.0	…
Developing countries	8.0	6.0	5.3	5.3	4.0	3.9	…
Asia pacific	7.3	5.2	4.4	4.7	3.3	3.2	…
Off-shore financial centers	55.9	51.9	41.8	37.8	32.4	31.5	…
FX-denominated loans to total loans 2/	-	21.7	15.2	11.0	10.6	9.7	…

Sources: FSA website and internal data, and "Financial and Economic Statistics" by the BoJ.
1/ For 1997–2001, the data refer to end-Dec. 1996–end Dec. 2000 respectively.
2/ This is the ratio of loans extended via overseas branches to total loans.

Table 4. Japan: Profitability, Liquidity, and Spreads, Domestic Private Banks, 1997–2002
(In percent, end-March, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	Sept. 2002
Earnings and Profitability							
ROA (pre-tax)	0.0	-0.6	-0.9	0.3	0.1	-0.7	0.0
ROE (pre-tax)	0.2	-20.0	-25.1	6.8	1.2	-19.5	0.4
Interest margin to gross income	47.4	51.7	53.6	46.7	61.3	63.4	62.7
Non-interest expenses to gross income	78.5	80.3	86.2	88.5	83.2	91.3	93.2
Personnel expenses to non-interest expenses	49.7	49.5	48.3	48.1	47.2	46.7	…
Trading and fee income to total income	7.6	7.7	8.4	7.8	11.6	13.6	15.5
Spread between average lending and deposit rates 1/							
City banks (7)	1.7	1.7	1.8	1.8	1.8	1.8	1.8
Trust banks (5)	1.7	1.6	1.6	1.7	1.7	1.7	1.6
Long-term credit banks (3)	1.0	0.8	0.8	1.0	1.1	1.1	1.2
Regional banks (64)	0.8	0.7	0.8	0.8	0.8	0.7	1.5
Regional banks II (54)	2.6	2.0	2.1	2.1	2.1	2.1	2.1
Liquidity							
Liquid assets to total assets 2/	25.2	26.6	24.9	28.0	32.1	31.2	32.7
Liquid assets to total short-term liabilities 3/	31.3	34.0	31.6	34.9	40.2	37.6	39.0
Liquid assets to total (non-interbank) loans	38.4	41.9	38.6	43.4	54.3	51.8	55.3
Average bid-ask spread in the securities market (in bps)	…	…	…	1.6	1.2	0.9	…
Average bid-ask spread in the FX market (in bps)	…	6.5	7.9	9.9	3.2	5.9	…
Amount of outstanding guarantees (in trillions of yen) 4/	30.9	33.2	30.4	27.5	25.7	24.3	23.0

Sources: FSA, "Analysis of Financial Statements of all banks" by the Japanese Bankers' Association, Bank of Japan “Financial and Economic Statistics.”

1/ Figures in parentheses in the first column are the number of institutions as of the end of September 2002.

2/ Liquid assets include cash and due from banks, call loans, receivables under resale agreements, bills bought, monetary claims bought, trading assets, trading account securities, money held in trust, and investment securities.

3/ Short-term liabilities include deposits, negotiable certificates of deposit, debentures, call money, payables under repurchase agreements, bills sold, commercial papers, and trading liabilities.

4/ Sum of acceptance and guarantees extended by total banks. End of previous calendar year for 1997–2000.

Table 5. Japan: Capital Adequacy, Domestic Private Banks, 1997–2002
(In percent, end-March, unless otherwise indicated)

	1997	1998	1999	2000	2001	2002	Sept. 2002
Regulatory capital (tier-1 capital) to risk-weighted assets							
City banks							
International active (5) 1/	9.0 (4.6)	9.3 (4.7)	11.9 (6.6)	12.4 (6.9)	11.7 (6.7)	11.1 (6.0)	10.9 (5.8)
Not internationally active (2)				12.7 (8.7)	12.0 (8.4)	8.7 (4.4)	7.8 (4.0)
Trust banks							
International active (2)	9.6 (5.5)	10.8 (6.1)	13.1 (7.7)	11.4 (7.0)	11.7 (6.7)	10.9 (6.2)	11.6 (6.6)
Not internationally active (3)	…	13.5	8.2 (7.6)	11.7 (7.2)	11.2 (6.6)	10.3 (5.7)	9.7 (5.3)
Long-term credit banks							
International active (0)	8.1 (4.2)	10.3 (5.2)	11.5 (6.3)	12.4 (6.8)	12.1 (6.8)	11.0 (5.5)	…
Not internationally active (2)	…	8.3 (4.3)	…	…	15.4 (9.6)	15.4	16.8 (12.6)
Regional banks							
International active (11) 2/	…	…	10.6 (7.6)	11.5 (8.1)	11.3 (8.1)	10.9 (8.0)	10.9 (8.0)
Not internationally active (53) 2/	4.2 (3.1)	9.0 (7.0)	8.3 (6.2)	9.5 (7.1)	9.5 (7.2)	9.2 (6.9)	9.4 (7.1)
Regional banks II							
International active (0) 2/	8.8 (6.2)	9.2 (5.7)	…	…	…	…	…
Not internationally active (54) 2/	4.4 (...)	6.1 (5.1)	5.0 (3.9)	8.1 (6.3)	8.1 (6.5)	8.1 (6.3)	8.6 (6.8)
All banks							
International active (18)	9.0 (4.7)	9.6 (4.9)	11.9 (6.9)	12.2 (7.1)	11.7 (7.0)	10.9 (6.2)	10.8 (6.1)
Not internationally active (114) 2/	4.4 (...)	7.7 (6.0)	7.2 (5.3)	9.7 (7.0)	10.0 (7.0)	9.4 (6.5)	9.0 (6.3)
Average capital-assets ratio							
City banks (7)	3.1	2.4	4.6	4.8	4.2	3.4	3.0
Trust banks (5)	3.3	3.1	5.6	5.9	5.2	4.0	3.8
Long-term credit banks (2)	2.8	2.8	3.9	4.4	4.6	4.1	8.2
Regional banks (64)	4.1	3.8	4.2	4.6	5.2	4.7	4.7
Regional banks II (54)	3.4	2.5	3.5	4.2	4.3	4.0	4.3
Memorandum item:							
Regulatory capital (tier-1 capital) to risk-weighted assets							
Major banks 3/							
Internationally active (8)	9.0 (4.7)	9.6 (4.9)	12.1 (6.7)	12.3 (6.9)	11.7 (6.7)	11.0 (5.9)	10.9 (5.9)
Not internationally active (5)	…	13.5 (12.9)	8.2 (7.6)	12.0 (7.7)	11.5 (7.1)	9.4 (5.0)	8.7 (4.6)

Sources: FSA, Japanese Bankers Association "Analysis of Financial Statements of all banks."

1/ Figures in parentheses in the first column are the number of institutions included as of the end of September, 2002.
2/ The definition changed as of end-March 1998. As for end-March 1997, the ratio is capital to total assets.
3/ Composed of the following 13 major banks: Mizuho (DKB, Fuji, IBJ, Yasuda Trust), MTFG (Tokyo-Mitsubishi, Mitsubishi Trust), UFJ (UFJ Bank, UFJ Trust), SMBC, Resona (Asahi, Daiwa), Chuo-Mitsui Trust, and Sumitomo Trust.

STRESS TESTING METHODOLOGY

1. Stress test estimates are based on data published in English versions of institutions' 2002 annual reports and other public websites.[1] Public data availability limited the possible scope of analysis as the authorities were not in a position to provide supervisory data or exposure estimates.

2. In calculating the stress effects of the interest rate shocks, data limitations require that foreign bonds are included with domestic positions. All bond positions are repriced using the same price change estimates that are implied by a 100 basis point increase in domestic yields. Japanese banks and insurance companies report only summary information on the maturity structure of their bond portfolios in the footnotes of their year-end financial statements and do not differentiate between fixed and floating rate debt. The analysis assumes that all fixed income portfolio positions are fixed rate.

3. The risk exposure generated by foreign exchange and off-balance sheet positions cannot be accurately determined from the data provided in institutions' annual reports. Foreign exchange risks are unlikely to be large for most Japanese banks and insurance companies. It has been reported that derivative positions are used to increase bank exposures to interest rate risk, but this claim can not be verified with publicly available data.

4. Risk-bearing capacities are gauged by comparing estimated shock induced losses to alternative accounting measures of institutions' shareholder capital. In one measure, losses are compared to the magnitude of book shareholders' equity in banks, and to shareholder equity plus a subset of reserve account items that are included in insurers' prudential solvency margin calculations and would qualify as Tier-1 capital under banking regulatory capital rules.[2] These accounting measures of equity capital assume that loan portfolios net of provisions are accurately valued and they give full value to banks' DTAs. Because DTAs cannot absorb losses, a second measure of risk-bearing capacity compares potential losses to adjusted shareholders' equity defined as shareholders' equity less an institution's DTAs. The analysis does not consider measuring the loss effects on banks' regulatory capital adequacy ratios (CARs) because banks' Tier-1 and Tier-2 capital positions are not disclosed in the English annual reports of many (primarily regional) banks.

5. The analysis does not explicitly consider the effects of government support mechanisms or the possible spillover effects of contagion. The Japanese banking and insurance sectors are extensively interconnected through cross institution share and

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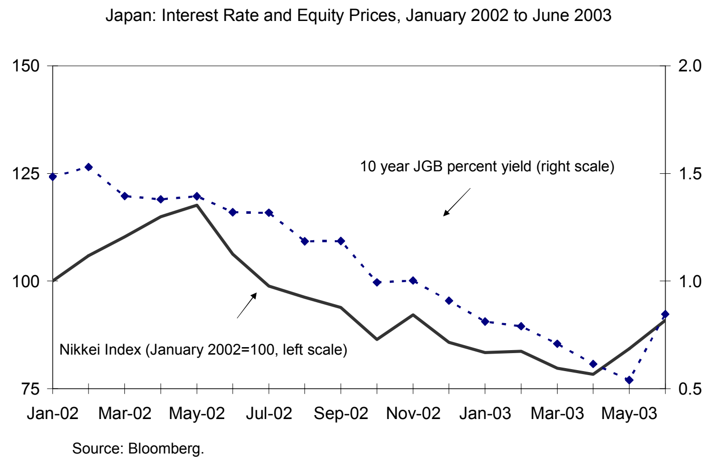
[1] For insurance companies, balance-sheet data was compiled by Fitch Ratings in a special report on "Japan's Major Life companies in 2001/02: Mid-sized Players Squeezed."

[2] Excluded, for example, are solvency margin items such as subordinated debt and future profits.

subordinated debt holdings. Absent credible government safety nets, losses in some institutions would likely have significant spillover effects on other institutions in the financial sector. Such contagion risks have not been quantified in the analysis.

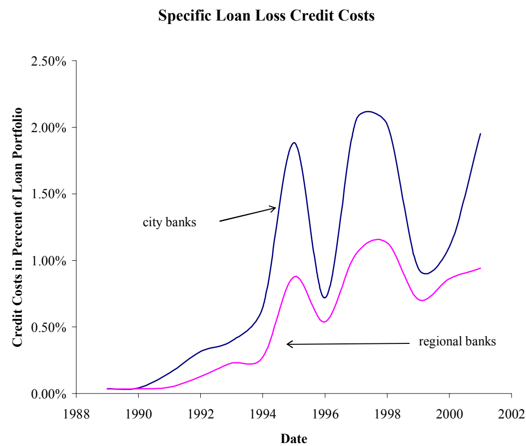
Stress Shock Calibrations

6. Market Risk: The equity and interest rate shock sizes each represent about a two-standard deviation movement in the underlying risk factors over a three-month horizon (sample period 1970–2000). In 2002, Japanese equity prices fell by more than 20 percent (intra year) while long term interest yields declined by nearly 100 basis points. The market risk shocks are not sized to reflect all possible stresses that may arise in crisis scenarios where interest rates rise and equity prices decline in the face of inflation, exchange rate pressures, solvency concerns, and a general loss of investor confidence. While these shocks may be undersized, they nevertheless provide useful information about financial sector exposures.



Source: Bloomberg.

7. Credit Risk: The recent average credit loss experience of regional and city banks appears in the adjacent figure. Including general loss provisions and losses associated with disposal of collateral, public data indicate that 3 (of 7) city banks reported credit losses that exceeded 3 percent of their loan portfolio value in the year ending March 31, 2002. Among the sample of regional banks, one bank exceeded a 4 percent expense ratio and a second bank very nearly recorded a 3 percent expense rate. The stress test examined banks' ability to absorb a credit loss of 3 percent of the value of their loan portfolios.



Source: Annual Report Data and staff calculations.

INTERNATIONAL MONETARY FUND

JAPAN

Financial System Stability Assessment
Supplementary Information

Prepared by the Monetary and Financial Systems and Asia and Pacific Departments

Approved by Stefan Ingves and David Burton

August 14, 2003

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I. INTRODUCTION

1. **Recent data and updated stress test analysis support the conclusions of the FSSA (SM/03/276) regarding weaknesses in the risk-bearing capacities of the financial system and the need to strengthen the capital base of the banking sector.** This supplement includes a revision to FSSA Box 4 that summarizes the results of an updated stress testing exercise, as well as several updated tables of financial sector indicators with the latest available data. The FSSA stress test, which was based on end-March 2002 annual report data, is updated here to include results based on publicly available end-March 2003 data. The sources of the data, the sample of institutions, the methodology used in the update, and the caveats that apply are the same as those in the original stress tests.

II. UPDATED STRESS TEST RESULTS

2. **The latest available data suggest the risk bearing capacities of city and cooperative central banks were further eroded in the year ending in March 2003, while the results for regional banks and insurance companies were mixed (Box 1).** Risk bearing capacity depends positively on shareholder equity and negatively on potential losses arising from shocks. The adverse results for city banks mainly reflect a fall in shareholder equity as a percent of assets. On average, city banks posted losses in FY2002 that reduced their shareholder equity despite new capital issues. City banks also rebalanced their portfolio away from equities and towards bonds, thereby increasing potential losses from higher interest rates while reducing those from lower equity prices. However, the reduction in potential losses from lower equity prices was more than offset by the fall in shareholder equity. On average, regional banks and insurance companies showed declines in equity risks but additional exposures to interest rate risk.

3. **Because these stress tests are static estimates and based on publicly available information, the results warrant some caveats.** Annual account data do not include sufficient detail to ensure all exposures are accurately measured. In particular, it is not possible to quantify exchange rate risk or the risks generated by off balance sheet positions including derivatives. Also, the stress tests do not account for any loss minimizing response on the part of banks and insurance companies, the impact of the shocks on insurers' liabilities, and the effects of the availability of safety nets. The tests reflect the vulnerabilities as of end-March 2003; since then, the government has recapitalized Resona Bank and there has been an increase in equity prices, while bond prices have fallen.

Box 1. Summary of IMF Staff Stress Test Results

The stress test sample includes 7 city bank financial groups, 21 regional banks, 2 central banks of credit cooperative financial institutions, and 10 life insurance companies. It represents 56 percent of the total assets of banks and cooperative financial institutions and 86 percent of the assets of the life insurance industry. Staff estimated stress test exposures using annual report data for end-March 2003. The market risk stress shocks are a 20 percent decline in equity prices and a 100 basis points increase in yields. The test includes a credit risk shock in which banks suffer losses equal to 3 percent of the book value of their loan portfolios. Insurers' credit losses are assumed to be 1.5 percent in respect of the higher quality of their credit portfolios. Loss bearing capacities are measured according to an institution's ability to absorb losses against shareholder equity value measured both gross and net of deferred tax assets (DTAs). For insurance companies, stress losses are measured against Tier 1 capital equivalents.

The financial sector group average stress test results show that these single market stress events consume a significant portion of the financial system's risk bearing capacity. Relative to their core capital, city banks and insurance companies have the largest equity exposures while the cooperative institutions' central banks have the largest interest rate risk exposures. Credit risks are less important for the life insurance sector. Foreign exchange exposures are reported to be modest in both banks and insurers, although public data do not provide the detail necessary to confirm this.

Group Average Stress Test Results

	shock	city banks 2003	cooperative central banks 2003	regional banks 2003	life insurance /1 2003
	Loss measured as a percentage of shareholder equity				
equity stress	20% decline in prices	44%	3%	9%	45%
interest rate stress	100 bps increase in yields	33%	72%	22%	38%
credit risk stress	3% credit loss on loan book	94%	35%	45%	10%
	Loss measured as a percentage of shareholder equity net of DTA				
equity stress	20% decline in prices	100% /2	3%	13%	69% /3
interest rate stress	100 bps increase in yields	98% /2	76%	30%	64% /3
credit risk stress	3% credit loss on loan book	232% /2	37%	65%	16% /3

Source: 2003 annual report data and IMF staff estimates.
1/ Measured against the balance of Tier 1 capital equivalents; credit risk shock is 1.5 percent for life insurers.
2/ Average excludes two institutions in which DTAs exceed shareholder equity.
3/ Average excludes one institution in which DTAs and Tier 1 capital equivalents are approximately equal.

Figure 1: Combined Market Stress Test Results for City and Cooperative Central Banks

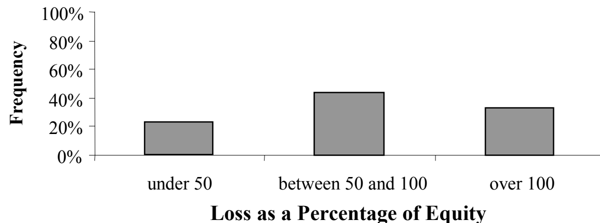
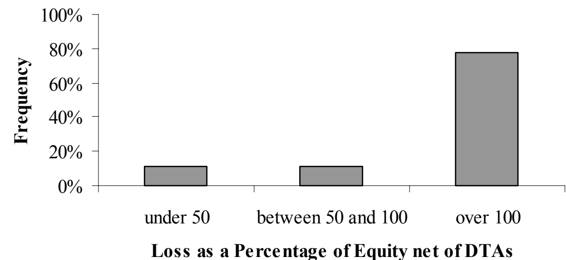


Figure 2: Combined Market Stress Test Results for City and Cooperative Central Banks



The distributional results for the combined market risk scenario (share prices decline by 20 percent and interest rates rise by 1 percent) are shown in Figures 1–4. The results show that a combination of market stresses may challenge the risk bearing capacity of many institutions (Figure 1). Corrected for the limited risk-bearing capacity of DTAs (which on average exceed 86 percent of city banks' shareholder equity in March 2003), measures of risk bearing capacity are further diminished (Figure 2). Regional banks (Figure 3) are less vulnerable to these market stresses. Estimates suggest that many life insurance companies (Figure 4) have significant exposures to equity and interest rate risk relative to their capital and reserve assets that are available to buffer losses.

Figure 3: Combined Market Stress Test Results for Regional Banks

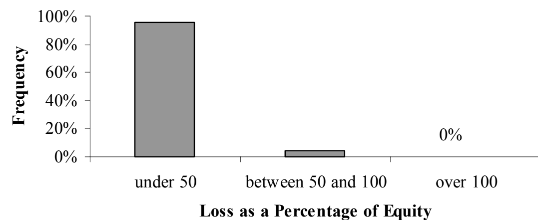
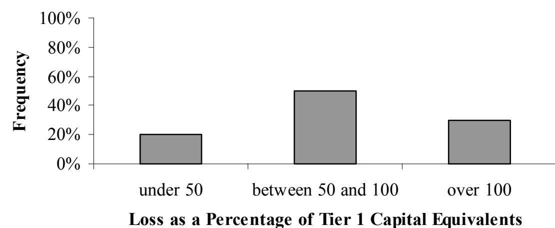


Figure 4: Combined Market Stress Test Results for Insurers



A combination of market risk stresses alone could deplete book shareholder equity in a number of banking institutions and test the required solvency margin buffers of some insurers. While bank operating profits are available to supplement banks' core capital buffers, operating margins remain thin in the current environment. The results highlight the increasing importance of government safety nets in sustaining depositors' and policy holders' confidence.

III. Update of Financial Sector Indicators

4. **The authorities provided end-March 2003 data (FY 2002) for selected indicators and the updated tables are attached.** The recent data do not change the overall assessment and recommendations of the FSSA. Key developments in FY 2002 are summarized below:

- Total bank and credit cooperative assets have declined accompanied by reductions in the number of branches and employees (Table 1).
- The shares of bank lending to four troubled sectors (construction, wholesale/retail, finance and insurance, and real estate) and to small and medium enterprises declined but still account for over 40 percent of total loans (Table 3).
- Bank profitability remains weak as the sector as a whole posted losses for the second consecutive year. Lending-deposit spreads are broadly unchanged and liquidity ratios rose. (Table 4).
- Banks' average capital adequacy ratios (CARs) declined but remain above minimum requirements (Table 5). Loan losses eroded capital in many banks but reductions in risk assets and the issuance of preferred shares helped to attenuate CAR declines. However, the quality of bank capital remains poor with deferred tax assets (DTAs) accounting for an even larger share of Tier-1 capital.
- Life insurers continue to face pressures from their equity exposures and high guaranteed yields on existing policies. Solvency margin ratios of the insurance companies have further declined as a result of valuation losses on marketable securities and shrinking gross premium income. They remain above the prudential minimum requirement (text table on page 12 of the FSSA).
- Progress in dealing with problem loans was mixed. Major banks charged off more loans, reducing the ratio of nonperforming loans (NPLs) to total loans to below 8 percent. NPL ratios for regional banks remain unchanged (text table on page 14 of the FSSA).

Table 1. Financial System Structure, end-March 2003 (Fiscal 2002) 1/

	Number of			Total assets			Deposits outstanding		Loans and disc. Outstanding	
	Institutions	Branches	Employees	Amount (trill. yen)	(% of Total)	(% of GDP)	Amount (trill. yen)	(% of Total)	Amount (trill. yen)	(% of Total)
Private depository institutions										
Banks										
City banks (consolidated)	7	2,655	95,422	407	21.6	81.6	248	22.7	223	28.0
Long-term credit banks	2	46	3,062	13	0.7	2.6	4	0.4	7	0.9
Trust banks	27	325	21,303	61	3.2	12.2	34	3.1	31	3.9
Regional banks	64	7,600	124,970	204	10.8	40.9	181	16.6	136	17.1
Regional banks II	53	3,790	53,538	61	3.2	12.2	55	5.0	43	5.4
Foreign banks	73	111	4,700	43	2.3	8.6	10	0.9	10	1.3
Others 2/	5	22	355	0.7	0.0	0.1	0.5	0.0	0.0	0.0
Cooperative financial institutions										
Shinkin banks and Shinkin Central Bank	327	8,015	126,179	139	7.4	27.9	120	11.0	72	9.0
Credit cooperatives and National Federation	192	1,996	24,779	19	1.0	3.8	17	1.6	9	1.1
Labor credit associations and Rokinren Bank	22	689	11,257	18	1.0	3.6	16	1.5	9	1.1
Agricultural cooperatives and Credit federations	1,085	...	...	130	6.9	26.1	124	11.4	26	3.3
Fishery cooperatives and Credit federations	510	...	...	4	0.2	0.8	3	0.3	1	0.1
Others	1	40	2,928	60	3.2	12.0	40	3.7	19	2.4
Non-depository financial institutions										
Insurance companies										
Life	43	15,807	380,864	179	9.5	35.9	n.a.	n.a.	47	5.9
Nonlife	59	4,869	87,501	31	1.6	6.2	n.a.	n.a.	4	0.5
Securities companies	276	2,069	87,455	77	4.1	15.4	n.a.	n.a.	n.a.	n.a.
Money market dealers	3	7	434	30	1.6	6.0	n.a.	n.a.	n.a.	n.a.
Others 3/	27,684	...	...	...	...	...	...	...	...	...
Public financial institutions										
Japan Post	1	24,773	62,422	242	12.8	48.5	239	21.9	0.7	0.1
Government financial institutions										
Development Bank of Japan	1	25	1,390	18	1.0	3.6	...	...	17	2.1
Japan Bank for International Cooperation	1	29	893	23	1.2	4.6	...	...	22	2.8
Finance corporations	6	257	8,967	125	6.6	25.0	...	...	120	15.1
Total financial system (excl. Bank of Japan)	30,442	73,125	1,098,419	1,884	100.0	377.6	1,092	100.0	797	100.0
Memorandum item:										
City banks' international operations	5	126	11,849	35	1.9	7.0	12	1.1	16	2.0

Sources: FSA, MOF, Japanese Bankers Association "Analysis of Financial Statements of all banks," Japan Post, and Shoko Chukin Bank.

1/ As of end-March 2003 for banks and as of the latest available date for other institutions.

2/ Includes one bridge bank and new types of banks such as internet banks.

3/ Includes consumer credit institutions, securities finance companies, and securities investment trust management companies.

Table 2. Ownership Structures of Major Institutions in the Financial Sector 1/
(Ownership share in percent, end-March 2003/Fiscal 2002)

	Local and Central Government	Financial Institutions	Securities Firms	Non-financial Corp.	Foreign Corp. and Individuals	Other Individuals
Major financial groups						
Mizuho Holdings	0.1	47.0	1.1	32.1	5.7	14.0
MTFG	0.0	42.6	1.1	30.7	14.1	11.5
SMBC	0.1	36.4	2.5	37.8	9.3	13.9
UFJ	0.0	32.1	2.5	39.4	10.7	15.3
Resona	0.1	28.8	1.9	42.3	3.8	23.1
Mitsui Trust Holdings	0.0	26.1	1.8	57.7	2.8	11.6
Sumitomo Trust	0.0	39.3	1.6	38.3	15.1	5.7
Major life insurers 2/						
Daido	0.0	27.5	1.4	58.6	5.6	7.0
Major nonlife insurers						
Aioi	0.0	25.1	1.3	40.0	17.0	16.7
Sompo Japan Insurance 3/	0.0	45.8	1.3	12.3	24.9	15.7
Nisshin Fire & Marine	0.0	58.4	0.4	12.9	1.7	26.5
Nissey Dowa General Insurance	0.0	70.8	0.6	11.6	4.9	12.2
Nipponkoa Insurance	0.0	43.0	0.3	15.4	29.9	11.5
Fuji Fire and Marine	0.0	20.2	0.6	33.5	26.1	19.6
Mitsui Sumitomo Insurance	0.0	37.7	1.0	17.3	28.2	15.9
Millea Holdings 4/	0.0	46.8	0.3	10.6	26.2	16.1
Major clearing houses and market makers						
Tokyo Stock Exchange 5/	0.0	0.0	100.0	0.0	0.0	0.0
Nomura Holdings	0.0	40.1	0.7	8.7	29.0	21.6
Nikko Holdings	0.0	26.1	1.0	6.5	50.4	16.0
Daiwa Securities Group	0.0	45.4	0.9	6.5	29.2	18.0

Sources: FSA and individual institutions' financial disclosures.

1/ These are based on disclosed information on ownership of common stocks by type of shareholders. For the major financial groups, shares in trust accounts are included.
2/ Of the top ten life insurers, Daido is the only listed joint stock company; the other nine insurers are mutual life companies, owned by policyholders.
3/ Yasuda Fire & Marine and Nissan Fire & Marine were merged to form Sompo Japan Insurance in July 2002.
4/ Millea Holdings is an insurance holding company of Tokyo Marine & Fire and Nichido Fire & Marine.
5/ These are subscriptions by member securities firms, some of which are owned by major financial groups.

Table 3. Asset Composition, Domestic Private Banks, 1998–2003
(In percent, end-March, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003
Total loans and discounts outstanding (in trillions of yen) 1/	514	503	493	475	447	432
Sectoral distribution of loans to total loans 1/						
Individuals	17.8	18.5	19.1	20.2	22.2	23.7
Local governments	1.6	1.9	1.8	1.8	2.2	2.6
Manufacturing	13.8	14.1	14.8	14.6	14.2	14.1
Non-manufacturing	65.3	64.2	63.3	62.4	60.2	59.3
of which:						
Construction	6.2	6.4	6.3	6.1	5.7	5.4
Wholesale, retail, and restaurants	15.2	15.2	15.2	15.0	14.2	13.8
Finance and insurance	10.0	9.5	9.1	8.8	8.8	8.7
Real estate	12.7	12.9	12.6	12.5	12.4	12.3
Memorandum item						
Small and medium enterprises (incl. finance and insurance)	50.5	49.3	46.8	49.4	48.2	45.5
Total external claims as a percent of total assets	12.1	11.2	9.1	10.0	10.2	8.6
Geographical distribution of external claims						
Developed countries	40.9	52.0	55.7	62.8	63.0	64.9
Developing countries	6.0	5.3	5.3	4.0	3.9	4.5
Asia pacific	5.2	4.4	4.7	3.3	3.2	3.7
Off-shore financial centers	51.9	41.8	37.8	32.4	31.5	28.4
FX-denominated loans to total loans 2/	21.7	15.2	11.0	10.6	9.7	…

Sources: FSA and "Financial and Economic Statistics" by the BoJ.

1/ End of previous calendar year for 1998–2001.
2/ This is the ratio of loans extended via overseas branches to total loans.

Table 4. Profitability, Liquidity, and Spreads, Domestic Private Banks, 1998–2003
(In percent, end-March, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003
Earnings and Profitability						
ROA (pre-tax)	-0.6	-0.9	0.3	0.1	-0.7	-0.6
ROE (pre-tax)	-20.0	-25.1	6.8	1.2	-19.5	-19.4
Interest margin to gross income	51.7	53.6	46.7	61.3	63.4	60.0
Non-interest expenses to gross income	80.3	86.2	88.5	83.2	91.3	...
Personnel expenses to non-interest expenses	49.5	48.3	48.1	47.2	46.7	46.3
Trading and fee income to total income	7.7	8.4	7.8	11.6	13.6	16.6
Spread between average lending and deposit rates						
City banks	1.6	1.6	1.7	1.7	1.7	1.6
Trust banks	0.8	0.8	1.0	1.1	1.1	1.2
Long-term credit banks	0.7	0.8	0.8	0.8	0.7	1.5
Regional banks	2.0	2.1	2.1	2.1	2.1	2.1
Regional banks II	2.4	2.3	2.4	2.5	2.5	2.5
Liquidity						
Liquid assets to total assets 1/	26.6	24.9	28.0	32.1	31.2	34.9
Liquid assets to total short-term liabilities 2/	34.0	31.6	34.9	40.2	37.6	41.0
Liquid assets to total (non-interbank) loans	41.9	38.6	43.4	54.3	51.8	56.9
Average bid-ask spread in the securities market (in bps)	…	…	1.6	1.2	0.9	…
Average bid-ask spread in the FX market (in bps)	6.5	7.9	9.9	3.2	5.9	…
Amount of outstanding guarantees (in trillions of yen) 3/	33.2	30.4	27.5	25.7	24.3	19.8

Sources: FSA, Japanese Bankers Association, and the BoJ "Financial and Economic Statistics."

1/ Liquid assets include cash and due from banks, call loans, receivables under resale agreements, bills bought, monetary claims bought, trading assets, trading account securities, money held in trust, and investment securities.
2/ Short-term liabilities include deposits, negotiable certificates of deposit, debentures, call money, payables under repurchase agreements, bills sold, commercial papers, and trading liabilities.
3/ “Acceptance and guarantees” extended by banks. End of previous calendar year for 1998–2000.

Table 5. Capital Adequacy, Domestic Private Banks, 1998–2003
(In percent, end-March, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003
Regulatory capital (tier 1 capital) to risk-weighted assets						
City banks						
International active (5) 1/	9.3 (4.7)	11.9 (6.6)	12.4 (6.9)	11.7 (6.7)	11.1 (6.0)	10.3 (5.3)
Not internationally active (2) 2/	...	...	12.7 (8.7)	12.0 (8.4)	8.7 (4.4)	6.7 (3.5)
Trust banks						
International active (2)	10.8 (6.1)	13.1 (7.7)	11.4 (7.0)	11.7 (6.7)	10.9 (6.2)	11.0 (6.1)
Not internationally active (3)	13.5 (12.9)	8.2 (7.6)	11.7 (7.2)	11.2 (6.6)	10.3 (5.7)	7.1 (4.1)
Long-term credit banks						
International active (0)	10.3 (5.2)	11.5 (6.3)	12.4 (6.8)	12.1 (6.8)	11.0 (5.5)	n.a.
Not internationally active (2)	8.3 (4.3)	n.a.	n.a.	15.4 (9.6)	15.4 (11.1)	17.0 (13.5)
Regional banks						
International active (10)	10.7 (7.6)	10.6 (7.6)	11.5 (8.1)	11.3 (8.1)	10.9 (8.0)	10.7(8.0)
Not internationally active (54)	9.0 (7.0)	8.3 (6.2)	9.5 (7.1)	9.5 (7.2)	9.2 (6.9)	9.1(6.8)
Regional banks II						
International active (0)	9.2 (5.7)	n.a.	n.a.	n.a.	n.a.	n.a.
Not internationally active (53)	6.1 (5.1)	5.0 (3.9)	8.1 (6.3)	8.1 (6.5)	8.1 (6.3)	8.2 (6.5)
All banks						
International active (18)	9.6 (4.9)	11.9 (6.9)	12.2 (7.1)	11.7 (7.0)	10.9 (6.2)	10.4 (5.7)
Not internationally active (114)	7.7 (6.0)	7.2 (5.3)	9.7 (7.0)	10.0 (7.0)	9.4 (6.5)	8.5 (5.9)
Average capital-assets ratio						
City banks (7)	2.4	4.6	4.8	4.2	3.4	2.1
Trust banks (5)	3.1	5.6	5.9	5.2	4.0	3.4
Long-term credit banks (2)	2.8	3.9	4.4	4.6	4.1	9.3
Regional banks (64)	3.8	4.2	4.6	5.2	4.7	4.5
Regional banks II (53)	2.5	3.5	4.2	4.3	4.0	4.0
Memorandum item:						
Regulatory capital (tier 1 capital) to risk-weighted assets						
Major banks 3/						
Internationally active (7)	9.6 (4.9)	12.1 (6.7)	12.3 (6.9)	11.7 (6.7)	11.0 (5.9)	10.4 (5.4)
Not internationally active (4)	13.5 (12.9)	8.2 (7.6)	12.0 (7.7)	11.5 (7.1)	9.4 (5.0)	6.8 (3.6)

Sources: FSA and Japanese Bankers Association "Analysis of Financial Statements of all banks."

1/ Figures in parentheses in the first column are the number of institutions included as of end-March 2003.

2/ The figure for not-internationally active city banks as of end-March 2003 includes the Saitama-Resona Bank.

3/ Composed of the following 11 major banks: Mizuho (Mizuho Bank, Mizuho Corporate Bank, Mizuho Trust), MTFG (Tokyo-Mitsubishi, Mitsubishi Trust), UFJ (UFJ Bank, UFJ Trust), SMBC, Resona, Chuo-Mitsui Trust, and Sumitomo Trust.

Text Tables from FSSA (SM/03/276) on Pages 12 and 14

Japan: Financial Soundness Indicators for the Insurance Sector, 1998–2003

(In percent, end-March, unless noted otherwise)

	1998	1999	2000	2001	2002	2003
Solvency ratio						
Life insurance companies	705.9	692.8	819.0	712.8	671.9	631.1
Non-life insurance companies	908.1	1,385.7	1,290.8	999.9	934.6	790.9
Nominal growth rate of gross premium income						
Life insurance companies	3.4	-5.0	-4.3	-2.4	-2.8	-1.7
Non-life insurance companies	-1.3	-4.8	-0.7	0.6	0.0	...
Net pre-tax earning as percent of total assets						
Life insurance companies	0.8	0.1	0.5	0.3	0.2	0.2
Non-life insurance companies	1.2	0.9	0.5	0.5	-0.8	...

Source: FSA and Life Insurance Association of Japan.

Japan: Nonperforming Loans, 1998–2003

(In percent, end-March, unless otherwise indicated)

	1998	1999	2000	2001	2002	2003
Nonperforming loans to total loans 1/	5.4	5.8	6.1	6.6	8.9	7.8
City banks	4.8	5.2	5.0	5.4	9.4	7.8
Trust banks	8.4	11.0	8.7	7.5	9.5	7.5
Long-term credit banks	10.0	9.1	9.0	10.0	9.6	6.2
Regional banks	3.7	4.9	5.6	7.0	7.7	7.7
Regional banks II	5.3	5.5	6.7	8.2	9.0	8.9

Sources: FSA and Japanese Bankers Association.
1/ Nonperforming loans are defined as "risk management loans," which include loans to borrowers in legal bankruptcy, past due loans by 3 months or more, and restructured loans.